PERFORMANCE AUDIT

PUBLIC SAFETY PERSONNEL RETIREMENT SYSTEM
ELECTED OFFICIALS' RETIREMENT PLAN

Report to the Arizona Legislature
By the Auditor General
September 1994
Report 94-6

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

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September 26, 1994

Members of the Arizona Legislature

The Honorable Fife Symington, Governor

Mr. Jack M. Cross, Administrator
Public Safety Personnel Retirement System
Elected Officials' Retirement Plan

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Public Safety Personnel Retirement System and Elected Officials' Retirement Plan. This report is in response to a May 5, 1993, resolution of the Joint Legislative Audit Committee. This performance audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

We found that the Public Safety Personnel Retirement System and the Elected Officials' Retirement Plan (administered by the same Fund Manager) are generally well managed. Both systems provide good benefits at reasonable costs, and have good investment performance. However, we believe brokerage commissions can be reduced by 25 percent and that the governing board should develop general policies to govern the hiring of brokers.

My staff and I will be pleased to discuss or clarify items in the report.

The report will be released to the public on September 27, 1994.

Sincerely,

Douglas R. Norton

Douglas R. Norton
Auditor General

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SUMMARY

The Office of the Auditor General has conducted a performance audit and Sunset review of the Public Safety Personnel Retirement System and the Elected Officials' Retirement Plan, pursuant to a May 5, 1993, resolution of the Joint Legislative Audit Committee. This performance audit was conducted as part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957.

The Public Safety Personnel Retirement System (PSPRS) is an agent multiple-employer retirement plan and the Elected Officials' Retirement Plan (EORP) is a cost-sharing, multiple-employer retirement plan. The PSPRS administers retirement benefits to various local, municipal, and state public safety personnel including police and firefighters; state and county investigators; and county sheriffs and deputies; while the EORP covers state and county elected officials, judges, and some city elected officials. As of June 30, 1993, 145 government employer groups involving 14,506 members participated in the PSPRS; 30 government employer groups and 1,173 members participated in the EORP. The PSPRS and the EORP are governed by the same five-member oversight Board.[1]

Our review of the two systems revealed that both systems appear to provide good benefits at reasonable costs, and investment performance has been excellent overall.

We did find, however, that PSPRS and EORP can reduce expenditures by lowering commissions paid for investment-related brokerage services. Currently, the systems will pay a broker five, six, or seven cents per share to execute stock trades with no apparent justification for the different fee levels. Lowering commission rates to no more than 5 cents per share would create an annual savings of more than $150,000. In addition, to ensure that potential cost savings are adequately pursued, the retirement systems' Fund Manager needs to play a more active role in overseeing brokers.

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(1) A third system, the Correctional Office Retirement Plan (CORP), is also administered by this Board, but has never been placed under the provisions of the Sunset law.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit and Sunset review of the Public Safety Personnel Retirement System and Elected Officials' Retirement Plan, pursuant to a May 5, 1993, resolution of the Joint Legislative Audit Committee. The audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

The Public Safety Personnel Retirement System (PSPRS) is an agent multiple-employer retirement plan and the Elected Officials' Retirement Plan (EORP) is a cost-sharing, multiple-employer retirement plan. Both were established to administer retirement benefits to eligible members. The PSPRS was created in 1968 to provide a uniform, consistent, and equitable statewide retirement program for various local, municipal, and state public safety personnel (including police and firefighters, state and county investigators, and county sheriffs and deputies). The EORP, created in 1970, provides retirement benefits to state and county elected officials, judges, and some city elected officials. In addition to retirement benefits, the PSPRS and the EORP offer long-term disability coverage and health insurance benefits. As of June 30, 1993, 145 government employer groups involving 14,506 members participated in the PSPRS, while 30 government employer groups and 1,173 members participated in the EORP.

A five-member governing board called the Fund Manager, administers the PSPSR, the EORP and a third plan, the Correctional Office Retirement Plan.(1) The Governor appoints three board members and the Legislature appoints two board members. The Fund Manager invests the systems' assets, sets employer contribution rates, determines eligibility for EORP members(2), and pays benefits. To fulfill these responsibilities, the Fund Manager retains a staff comprised of 12 full-time and two part-time positions, including a fund investment administrator, and utilizes the services of outside professional advisors, including investment counsel and consulting actuaries. Administrative and investment expenses for both the PSPRS and the EORP totaled $813,832 in fiscal year 1993.(3)

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(1) The CORP has never been placed under the provisions of the State's Sunset law and was not reviewed as a part of this audit.

(2) Each employer of the PSPRS is represented by a five-member Local Board that determines eligibility for membership, service credits, and benefit eligibility.

(3) Does not include $623,052 in commissions paid to investment brokers.

The Public Safety Personnel Retirement System And The Elected Officials Retirement Plan Offer Competitive Benefits At Reasonable Cost

Benefits provided by Arizona's PSPRS are competitive with those offered by similar systems in other states. A June 1991 survey conducted by the National Conference of State Legislatures reveals that the benefits provided to Arizona's PSPRS members are in line with those offered by other states' public safety retirement plans. For example, the survey found that, like Arizona, most states use a salary multiplier of 2.5 percent to determine a member's annual benefit amount.(1) Benefit factors ranged from a low of 1.5 percent in Tennessee to a high of 3 percent in Louisiana, Nebraska, and New Mexico. In addition, the years of service required for Arizona PSPRS members to receive full retirement benefits are low in comparison to similar systems in other states. Of the 30 states that allow for retirement based solely on years of service, Arizona is one of only 11 states that allows for retirement with full benefits after 20 years of credited service. Nineteen states require at least 25 or more years of service to retire with full benefits.

Furthermore, Arizona's PSPRS offers these comparable benefits at relatively low contribution rates. Contributions from both employers and employees are used to help accumulate the monies needed to fund the PSPRS pension obligations. Arizona's combined contribution rate for employers and employees totaled 16.38 percent for fiscal year 1993. At our request, an actuarial firm provided information on other public safety retirement system contribution rates. Their analysis of 11 systems found that the average contribution rate for employers and employees in these systems was 26.68 percent, considerably higher than Arizona's rate.

Arizona's Elected Officials' Retirement Plan also appears to offer competitive benefits at a reasonable cost. We found benefits provided by Arizona's Elected Officials Retirement Plan are generous in comparison to those offered by the Arizona State Retirement System and the Public Safety Personnel Retirement System. For example, EORP's 4 percent benefit factor is double ASRS' benefit factor and also higher than PSPRS's benefit factor. While limited to receiving 80 percent of their final annual salary, EORP members can achieve this benefit level in a much shorter time than either ASRS members or PSPRS members. Consequently, an EORP member could receive double the retirement income of an ASRS member given identical salary histories and years served. For fiscal year 1993, the contribution rate for EORP employers averaged 16.55 percent, with the member's rate statutorily set at 7 percent.

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(1) Arizona's benefit factor is actually 2.5 percent for the first 20 years of service, plus 2 percent for years 21 through 24, and 2.5 percent for years 25 and over.

Prudent Funding Mechanisms And Solid Investment Performance Have Enabled The Systems To Meet Their Pension Obligations

The Public Safety Personnel Retirement System and the Elected Officials' Retirement Plan are financially strong. As of June 30, 1993, the PSPRS assets exceeded liabilities by approximately $93 million, while the EORP assets exceeded liabilities by almost $8 million. As a result, both systems have adequate resources to meet their current pension obligations.

Prudent funding policies have been established to ensure that sufficient assets are accumulated to pay benefits when due. Both the PSPRS and the EORP use accepted actuarial methods to determine required employer contribution rates, to describe the plan's current financial position, and to analyze changes in the plan's condition. A recent review by an independent actuarial firm under contract with both the PSPRS and the EORP found that benefit obligations are being funded as incurred.

Solid investment performance has also contributed to the financial strength of both funds. Prudent investment transactions guided by specified investment parameters, coupled with employer and member contributions, have allowed assets to increase substantially over the past ten years. As of June 30, 1993, the PSPRS assets totaled almost $1.8 billion, while the EORP assets totaled approximately $129 million. Both systems have also experienced excellent rates of return on investments. Over the past five years, the PSPRS annualized rate of return on domestic equity investments was 14.6 percent, vs. 14.2 percent for the Standard and Poor's 500 stock index. The PSPRS fixed-income investments also outperformed the Lehman Aggregate Index for the same cumulative five-year period. The EORP has also outperformed the S & P 500 and Lehman index in four of the past five years.

Audit Scope

Our review of the Public Safety Personnel Retirement System and the Elected Officials' Retirement Plan revealed few problems. As described above, both systems appear to provide good benefits at reasonable costs, and investment performance has been excellent overall. We did find, however, that commission rates paid to investment brokers could be reduced and the broker selection process could be improved (see Finding, page 5).

The audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Fund Manager, fund administrator, and staff of the Public Safety Personnel Retirement System and the Elected Officials' Retirement Plan for their cooperation and assistance throughout the audit.

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FINDING

THE RETIREMENT SYSTEMS' GOVERNING BOARD NEEDS TO EXERCISE GREATER CONTROL OVER FEES PAID TO BROKERS

More stringent management of brokers used by the Public Safety Personnel Retirement System (PSPRS) and the Elected Officials' Retirement Plan (EORP) to execute investment transactions could: 1) reduce agency expenditures by more than $150,000 annually, and 2) ensure greater protection against potential abuse.

A retirement system's investment performance is a key measure in evaluating the effectiveness of its money management. In that regard, the PSPRS and the EORP have done well. As noted on page 3, investment earnings for the two systems compare favorably to the standard market indexes and the investment earnings of other pension funds.

Our review, therefore, focused on another aspect of the systems' money management function: whether the cost of managing investment transactions has been adequately controlled. We concentrated our efforts on fees paid to brokers who invest the PSPRS' and the EORP's assets since this represents a major cost component of this function.

Commissions Paid To Brokers Can Be Reduced

The PSPRS and the EORP can reduce annual expenditures by lowering commissions paid for brokerage services. Brokers employed by the two systems are private intermediaries whose chief function is to execute stock or bond trades. Our audit found that commissions paid for stock trades vary, and, overall, are unnecessarily high. Based on the current volume of trades executed by the two systems, we believe that brokerage expenses can be reduced $150,000 or more annually.

Brokerage services — The PSPRS and the EORP currently utilize the services of 11 private brokerage firms. The primary service provided by these brokers is to execute transactions at or below a price set by the systems' fund administrator. On occasion, these brokers may also counsel the administrator on the timing of a particular transaction. Likewise, these firms periodically provide market research to assist the administrator in identifying investment opportunities.

Commission costs — Commissions paid to brokers who trade stock on behalf of the PSPRS and the EORP vary. Depending on the broker selected to execute a transaction, the systems will pay a broker either five, six, or seven cents per share to execute stock trades.[(1)] Charges for investment counseling and market analysis noted above are built into these cost figures. While these commissions at first may not appear significant, brokerage fees paid by the systems and financed by both member and employer contributions are in fact quite substantial. For example, in fiscal year 1993 alone, brokers earned commissions of nearly $650,000 by trading almost 10 million shares of stock on behalf of the two systems.

Commissions can be reduced — Our review showed that commission costs can be reduced by almost 25 percent with no impact on service being provided. As noted above, some brokers earn higher commissions than others. However, we found no apparent justification for the different fee levels. For example, all 11 brokers used by the two systems provide essentially the same service. Moreover, a survey of those brokers earning six and seven cents per share revealed that most would be willing to reduce their commissions to five cents a share without any reduction in service.

Why then are some brokers paid more than others? According to the fund administrator, commissions are based solely on the length of time a broker has conducted business for the two systems, with those brokers who have served the systems longer receiving a higher rate. The administrator agreed that this practice should be discontinued, and that commissions should be set at no more than five cents per share of stock traded. Based on fiscal year 1993 trade levels, such a reduction would result in an annual savings of over $150,000.

Our review suggests that even greater reductions may be possible. As noted previously, brokers factor supplemental services, such as investment counseling and market analysis, into the commission rates they assess. However, the administrator has said that these services are not essential in all cases. For example, he cited four brokers, accounting for approximately 40 percent of the systems transactions and charging up to 7 cents per share, whose counseling and market analysis are expendable. This being the case, we believe the systems are in a position to seek out more modestly priced brokers. For example, without the extra charges associated with investment counseling and market analysis, our analysis showed that the systems can procure the services of brokers for approximately three cents per share. If the two systems were able to conduct 40 percent of their transactions at three cents a share, with the remaining shares traded at five cents, they would lower their brokerage expenses (based on fiscal year 1993 trade levels) by 36 percent, for annual savings of about $232,000 a year. While the fund administrator believes that conducting a portion of the PSPRS and the EORP's transactions at three cents per share is viable, he did express concern regarding whether brokers earning this amount would work as vigorously to obtain the best trading price. Reduced performance

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(1) Brokers do not earn commissions for executing bond transactions. Rather, they earn money by keeping the difference between the buy-or-sell price accepted by the fund administrator, and the price the broker is able to negotiate in the marketplace.

in this area could offset the cost savings resulting from lower commissions. We agree that only brokers who can obtain competitive trading prices should be retained by PSPRS and EORP.

There may be other opportunities to reduce brokerage expenses as well. The fund administrator, for example, has stated he may not need 11 brokers to effectively execute trades, and that reducing the number of brokers could be used as an incentive for brokers to lower their commission rates in exchange for executing a higher volume of transactions.

More Systematic Oversight By The Retirement Systems' Governing Board Is Needed

The PSPRS and the EORP's governing board, referred to as the Fund Manager, needs to become more involved in overseeing brokers. The PSPRS and the EORP's governing board should increase its oversight role by developing written policies and procedures which:

- Require the administrator to seek out, use, and evaluate brokers in a manner that includes cost as an important criterion; and

- Exert greater control over the systems' use of brokers. Our review found that the current arrangement between the fund administrator and the systems' brokers, in which the administrator may freely select and retain brokers, determine commission amounts, and apportion business, leaves the systems vulnerable to improper acts. Written procedures could help protect the PSPRS and the EORP against potential abuse by establishing guidelines that compel the administrator to justify his use of brokers, including the manner in which business is apportioned.

RECOMMENDATION

The Public Safety Personnel Retirement System and the Elected Officials' Retirement Plan Fund Manager should develop written procedures in order to ensure that costs for brokerage services are minimized, and to protect the systems against illicit activity.

These procedures should include:

- Criterion for selecting, using, and retaining brokers that includes cost;
- Provisions for ensuring that any discrepancies in pricing are adequately justified; and
- Guidelines for apportioning business among brokers.

SUNSET FACTORS

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether the Public Safety Personnel Retirement System and the Elected Officials' Retirement Plan should be continued or terminated.

1. Objective and purpose in establishing the agency.

The Public Safety Personnel Retirement System (PSPRS) and the Elected Officials' Retirement Plan (EORP) were established to administer retirement benefits to eligible members. The Public Safety Personnel Retirement System was created in 1968 to provide a uniform, consistent, and equitable statewide retirement program for various local, municipal, and state public safety personnel. The Elected Officials' Retirement Plan, created in 1970, has evolved to cover state and county elected officials, judges, and some city elected officials. In addition to pension benefits, disability and health benefits are also provided.

The Fund Manager, consisting of five appointed members, is responsible for the administration and investment activities of both the PSPRS and the EORP. The Fund Manager develops investment guidelines, investment policies, and funding objectives with the assistance of independent investment counsel. A fund administrator, employed by the Fund Manager, is responsible for collecting and refunding contributions from members and employers, disbursing benefits to qualified members in a timely manner, and investing monies in a safe and prudent manner to meet investment objectives.

2. The effectiveness with which the agency has met its objectives and purpose and the efficiency with which the agency has operated.

In general, the Fund Manager appears to be effective in providing retirement income and other benefits to eligible members at a reasonable cost. According to agency personnel, as of March 1994, 4,203 members are receiving monthly retirement benefits from either the PSPRS or the EORP. The cost of providing these benefits has been kept low due to the solid investment performance of both funds. For example, annual reports for both the PSPRS and the EORP indicate the funds have continued to outperform the market indexes on a long-term basis. In addition, investment performance has consistently exceeded the actuarial yield prescribed by the Fund Manager. Furthermore, both the PSPRS and the EORP are over 100 percent funded. As a result, PSPRS employer contributions have decreased more than 10 percent over the past 20 years, from a high of 22.13 percent in fiscal year 1973 to 8.73 percent in fiscal year 1993. However, while the Fund Manager is operating quite efficiently, we found the fund could save over $150,000 annually by exercising greater control over fees paid to outside brokers who conduct investment transactions on behalf of the two systems (see Finding, pages 5 through 8).

3. **The extent to which the PSPRS and the EORP have operated within the public interest.**

The agency has operated within the public interest by providing a commendable retirement program at a reasonable cost. Members, employers, and taxpayers all benefit from the agency's operation. Members benefit from the prudent operation of a retirement system which has and hopefully will continue to accumulate sufficient assets to ensure payment of retirement benefits to all eligible members. Employers benefit by being able to offer potential and existing employees a retirement program at a reasonable cost. In addition, the fund's solid investment performance has resulted in lower contribution requirements, which benefit employers, employees, and taxpayers alike.

4. **The extent to which rules adopted by the agency are consistent with the legislative mandate.**

Neither the PSPRS or the EORP have specific statutory authority to promulgate rules and regulations. The Fund Manager does have the authority to develop, and has issued, investment guidelines, statements of investment policy, and fund objectives.

5. **The extent to which the agency has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.**

Although the Fund Manager has not promulgated rules and regulations, it does regularly hold meetings to discuss investments, investment strategies, administrative matters, and other issues. Our review found these meetings are appropriately posted in compliance with the open meeting law.

6. **The extent to which the agency has been able to investigate and resolve complaints that are within its jurisdiction.**

The Fund Manager does not have specific statutory authority to investigate and resolve complaints.

7. **The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation.**

A.R.S. §38-848(M) authorizes the Attorney General or an attorney approved by the Attorney General to represent the Fund Manager in any legal proceeding. At present, a private law firm is representing the Fund Manager in several cases that are in litigation.

8. **The extent to which the agency has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandate.**

Numerous technical and administrative changes have been made to statutes pertaining to both the PSPRS and the EORP over the years. However, these changes were made to either clarify statutory language or bring state statutes in compliance with federal law. According to agency personnel, there are no deficiencies in their enabling statutes which prevent them from fulfilling their statutory mandate.

9. **The extent to which changes are necessary in the laws of the agency to adequately comply with the factors listed in the sunset laws.**

The Fund Manager is considering requesting changes to broaden its investment authority. For example, the Fund Manager would like to have specific statutory authority to invest in a wider array of stocks. Currently it is unclear whether the Fund Manager has authority to trade over the counter stocks other than bank or insurance stocks. In addition, the Fund Manager would like specific statutory authority to invest in real estate, limited partnerships, and limited liability corporations.

10. **The extent to which the termination of the agency would significantly harm the public health, safety or welfare.**

The Legislature could terminate the agency, however, a member's retirement or disability benefit may not be changed since members of the ASRS have a constitutionally protected property interest in the funds. Even if the agency was terminated, the state would still need an administrative mechanism to distribute benefits.

11. The extent to which the level of regulation exercised by the agency is appropriate and whether less or more stringent levels of regulation would be appropriate.

Since the agency is not regulatory, this factor does not apply.

12. The extent to which the agency has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.

The Fund Manager contracts out several types of services, some of which are statutorily required. For example, an independent investment firm advises the Fund Manager on investments. The Fund Manager also contracts with an actuary to provide actuarial valuations of the fund. In addition, contracted services are used to meet the Fund Manager's legal, banking, and auditing needs. Furthermore, the Fund Manager uses independent brokers to execute stock and bond transactions.

Agency Response

PUBLIC SAFETY PERSONNEL RETIREMENT SYSTEM
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September 19, 1994

Mr. Douglas R. Norton
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Dear Mr. Norton:

This letter is in response to your report on the Public Safety Personnel Retirement System and the Elected Officials' Retirement Plan.

We would first like to note the professional and thorough staff that was assigned to our review. They cut quickly to the important issues and kept their time demands on me and my staff at a minimum. Also, we would like to thank you for your positive comments about our management of the Plans--specifically our cost-conscious management and our excellent investment performance. Having been an auditor, I know that the auditor's job is generally to look for what is wrong, rather than what is right.

In general, we agree with your finding and have begun to implement it. In fact, commissions for brokerage services were one of the first areas researched when I first took over as Administrator in 1986. At that time, the Plans were paying an average of about 14-cents per share, with the price varying based on the price of the stock. After my research, the Plans cut the brokerage rate from the variable average of 14-cents to a flat 7-cents per share. Since then, if one of my brokers changed firms or a new broker was added, that broker was required to beat the 7-cent price the Plans were already receiving. This was done to test for any change in service level and to see how low the brokers would go. We had been contemplating a reduction of fees to 5-cents a share for some time. Your research supported our idea that we could probably lower all of our brokers to the 5-cents per share level. I sent out a letter dated August 16, 1994, resetting commissions to the 5-cents per share level for all brokers used by the Plan with the new rates effective retroactively to July 1, 1994. We will continue to study possible further savings as suggested in the narrative portion of your report.

You have also suggested a need for the Fund Manager to have more direct oversight over brokerage services. I want to point out that the Fund Manager has always received detailed information on commissions paid on a regular basis. The board receives a copy of the stocks bought and stocks sold reports which contain the commission rate (5-cents, 6-cents or 7-cents) and the broker name for each transaction. The Fund Manager also receives and approves a copy of the Annual Report which contains a copy of the Schedule of Commissions Paid to Brokers by broker for that fiscal year.

The broker's personal investment knowledge, the firm's investment research, and company's ability to complete transactions can have a great affect on investment performance. This is why, in nearly all cases, the portfolio manager is granted the authority to select brokers. For example, one-half of a one percent change in investment returns for the PSPRS would result in a $10 million change in investment returns. This is about 70 times the savings projected in your report.

In order to improve the Fund Manager's oversight, staff has drafted a provision that was added to the Statement of Investment Policy. This provision requires that any future changes in brokers or brokerage rates be approved by the Fund Manager.

Sincerely,

Jack M. Cross

Jack M. Cross
Administrator

JMC:rrz