



## **CRS Report for Congress**

# **Railroad Retirement Board: Trust Fund Investment Practices**

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### **Summary**

Starting in 2002, a significant portion of Railroad Retirement Board (RRB) assets have been invested in private stocks, bonds, and other investments. Prior to the Railroad Retirement and Survivors' Improvement Act of 2001 (P.L. 107-90), surplus railroad retirement assets could only be invested in U.S. government securities — just as the Social Security trust funds must be invested. The 2001 act established the National Railroad Retirement Investment Trust (hereafter, the Trust) to manage and invest part of the RRB's assets in the same way that the assets of private-sector and most state and local government pension plans are invested. The remainder of RRB's assets continue to be invested solely in U.S. government securities.

Congress structured the Trust to assure independence of investment decisions and limit political interference. It also aimed to increase railroad retirement system funding, add enhanced benefits, potentially reduce taxes, and protect system financing in case of market downturns. The Trust's assets are invested in a diversified portfolio, both to minimize investment risk and to avoid disproportionate influence over an industry or firm. The Trust's assets are included in the federal budget. Since the Trust is a nongovernmental agency, it is not subject to the same oversight as federal agencies. However, the act requires an annual management report to Congress.

To date, the Trust's performance has exceeded the expectations of the bill's drafters, who assumed nominal annual returns of 8%. From FY2003 to FY2006, the Trust's annual returns averaged 14%. The Trust's rates of return compare favorably to its benchmarks and to those of defined benefit pension funds. As the Trust's investment portfolio has diversified over time, its administrative expenses have steadily increased (to 15 basis points in FY2006) but remain very low compared to industry standards.

The goal of this report is to inform readers about the Trust, which is of particular interest to policymakers exploring the option of collective investment of the Social Security trust funds or establishing other private investment funds within the federal government. The report will not be updated.

## Background

The Railroad Retirement Act (45 U.S.C. § 231) authorizes retirement, survivor, and disability benefits for railroad workers and their families.<sup>1</sup> The Railroad Retirement Board (RRB), an independent federal agency, administers these benefits. Workers covered by the RRB include those employed by railroads engaged in interstate commerce and related subsidiaries, railroad associations, and railroad labor organizations. These benefits are earned by railroad workers and their families in lieu of Social Security.

**RRB Benefits.** Railroad retirement benefits are divided into two tiers. Tier I benefits are generally computed using the Social Security benefit formula, on the basis of earnings covered by either program. In some cases, RRB tier I benefits can be higher than comparable Social Security benefits. For example, RRB beneficiaries may receive unreduced tier I retirement benefits as early as age 60 if they have at least 30 years of railroad service; Social Security beneficiaries may receive unreduced retirement benefits only when they reach their full retirement ages (currently rising from age 65 to 67). RRB tier II benefits are similar to private pension benefits and are based only on railroad work.<sup>2</sup>

## History of the Trust

Starting in 2002, a significant portion of railroad retirement assets have been invested in private stocks, bonds, and other investments. Prior to the Railroad Retirement and Survivors' Improvement Act of 2001 (P.L. 107-90), surplus railroad retirement assets could only be invested in U.S. government securities — just as the Social Security trust funds must be invested.<sup>3</sup> The 2001 act established the National Railroad Retirement Investment Trust to manage and invest assets in the Railroad Retirement Account in the same way that the assets of private-sector retirement plans are invested.<sup>4</sup> The Railroad Retirement Account is used to fund RRB tier II benefits and supplemental annuities. This account is also used to pay for tier I benefits that are higher than equivalent Social Security benefits, such as early retirement benefits for railroad employees with at least 30 years of railroad service. Assets in the Social Security Equivalent Benefits Account (which is used for RRB tier I benefits that are equivalent to Social Security benefits) continue to be invested solely in U.S. government bonds, as required by law.

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<sup>1</sup> For more explanation of RRB, see CRS Report RS22350, *Railroad Retirement Board: Retirement, Survivor, Disability, Unemployment, and Sickness Benefits*, by Kathleen Romig. This report focuses only on the retirement, survivor, and disability benefits authorized by the Railroad Retirement Act. The RRB also administers unemployment and sickness benefits.

<sup>2</sup> Railroad employers also finance a supplemental annuity program for certain railroad employees hired before October 1981. General revenues finance a vested dual benefit for certain railroad employees who were eligible for benefits before 1975.

<sup>3</sup> The Social Security trust funds may not be invested in private markets. For more information on current practices, see CRS Report RS20607, *Social Security: Trust Fund Investment Practices*, by Dawn Nuschler. For more information on investing Social Security in private markets, see CRS Report RL30571, *Social Security Reform: The Issue of Individual Versus Collective Investment for Retirement*, by David S. Koitz.

<sup>4</sup> See also Railroad Retirement Board, *National Railroad Retirement Investment Trust*, at [<http://www.rrb.gov/mep/nrrit.asp>] for background information on the Trust.

## Structure of the Trust

**Independence.** Congress structured the Trust to be independent and to resist political interference. The Trust is independent of the Railroad Retirement Board (RRB) and is not part of the federal government. It has no responsibilities for administering RRB benefits. The Trustees of the Trust are required to act solely in the interest of the RRB and the participants in the railroad retirement system. The fiduciary rules governing the Trustees are similar to those required by the law that governs the private pension system, the Employee Retirement Income Security Act (ERISA).<sup>5</sup>

The board of the Trust is made up of seven Trustees who have expertise in managing financial investments and pension plans. Three of the Trustees are selected by railroad labor unions, three by railroad management, and one by the other six Trustees. Each of the Trustees' terms is three years. The Trustees hire a professional staff to handle day-to-day operations of the Trust and independent investment managers to invest the assets of the Trust according to the investment guidelines established by the Trustees.

Each investment manager may control no more than 10% of the Trust's assets. Each manager must vote all proxies he or she holds in the Trust's portfolio in the sole interest of railroad retirement participants and beneficiaries, in accordance with written guidelines provided by the Trust. Votes must also be recorded and provided to the Trust upon request. Finally, all investment managers must certify each year that all proxies have been voted in the sole interest of railroad retirement participants and beneficiaries.<sup>6</sup>

**Goals.** Congress designed the Trust to increase RRB funding. Investing railroad retirement funds in private markets was expected to yield higher average annual returns than investing solely in government securities. The higher returns were intended to pay for the enhanced benefits that were established in the act and to potentially reduce future tax rates for railroad employers and employees.<sup>7</sup>

The Trust is also designed to maintain four to six years' worth of benefits in case of lower-than-expected returns. In order to maintain this balance, the tier II tax is set to automatically adjust to maintain the fund balance at four to six years. This tax adjustment would not require congressional action.

**Investment Guidelines.** The assets in the Trust are invested in a diversified portfolio, both to minimize investment risk and also to avoid disproportionate influence over a particular industry or firm. The investment guidelines adopted by Trustees include a target asset allocation developed by the Trust's investment staff in consultation with an independent investment advisory firm. As shown in detail in **Table 1**, the target allocation to equity (i.e., stock) is 55%. The target allocation to fixed income (i.e., bonds

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<sup>5</sup> See CRS Report 95-926, *Regulating Private Pensions: A Brief Summary of ERISA*, by Patrick Purcell.

<sup>6</sup> For more, see the National Railroad Retirement Investment Trust, *National Railroad Retirement Investment Trust Annual Management Report for Fiscal Year 2006*, Appendix F, available at [<http://www.rrb.gov/pdf/nrrit/appendicesFY2006.pdf>].

<sup>7</sup> H.Rept. 107-082, Railroad Retirement Survivor's Improvement Act of 2001.

and cash) is 35%. Finally, the target allocation to alternative investments is 10%. Outside investment managers hired by the Trust invest the assets according to these guidelines. The resulting investment performance is monitored by the Trustees and the Trust's Chief Investment Officer.

**Table 1. Trust Target Asset Allocation, FY2006**

Asset Class	Allocation (%)
<b>Equity</b>	<b>55</b>
<i>Domestic</i>	30
<i>International</i>	20
<i>Private</i>	5
<b>Fixed Income</b>	<b>35</b>
<b>Alternative Investments</b>	<b>10</b>
<i>Commodities</i>	5
<i>Real Estate</i>	5

**Source:** NRRIT, *National Railroad Retirement Investment Trust Annual Management Report*, FY2006.

**Oversight.** Since the Trust is an independent nongovernmental agency, it is not subject to the same oversight as federal agencies. However, the RRB has the authority to bring a civil action to enforce provisions of the act. The act outlines specific reporting requirements, including an annual management report to Congress. This report must include a statement of financial position, a statement of cash flows, a statement on internal accounting and administrative control systems, and any other information necessary to inform Congress about the operations and financial condition of the Trust. The financial statements must be audited by independent public accountants. A copy of the annual report and audit must be submitted to the President, the RRB, and the Director of the Office of Management and Budget (OMB).

**Accounting in the Federal Budget.** As required in the 2001 act, purchases and sales by the Trust initially produce no direct budgetary cost or income.<sup>8</sup> The law did not prescribe the treatment of unrealized capital gains and losses on the Trust's investments. The Congressional Budget Office (CBO) and OMB agreed that any capital loss or gain resulting from changes in market prices would be recognized in the year in which the price change occurs, and interest payments and dividends would be recorded as offsetting receipts.<sup>9</sup> As a result, income and capital gains reduce outlays and the deficit, and losses increase them. This reflects the change in real economic resources available to the

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<sup>8</sup> For budgetary purposes, purchases by the Trust are not considered outlays, but as an exchange of assets of equal value; redemptions are not considered offsetting receipts. This differs from long-standing budgetary rules, which usually treat an investment in nonfederal securities as the purchase of an asset, recording both an obligation and an outlay equal to the purchase price during the year of the purchase.

<sup>9</sup> For more information on accounting for government investment in private markets, see Congressional Budget Office, *Evaluating and Accounting for Federal Investment in Corporate Stocks and Other Private Securities*, January 2003, available at [<http://www.cbo.gov/ftpdoc.cfm?index=4023&type=0>].

government as the value of the Trust changes. As for future performance, both CBO and OMB use risk-adjusted rate of return assumptions — that is, they assume that the Trust's investments will earn the Treasury bond rate.

## Performance of the Trust

To date, the Trust's performance has exceeded the expectations of the bill's drafters. It was assumed that investments by the Trust would earn an average annual return of 8%.<sup>10</sup> (Figures in this report are not adjusted for inflation, i.e., in nominal terms.) From FY2003-FY2006, the Trust's annual returns have averaged 14%. Railroad retirement funds have been invested through the Trust starting in September 2002. A total of \$21.3 billion has been transferred to the Trust, mostly during its first two fiscal years. By September 30, 2007, the Trust had grown to \$32.7 billion, in addition to \$5.0 billion in earnings that were used to pay RRB benefits. The Trust earned a total of \$16.4 billion from its inception to the end of FY2007.<sup>11</sup>

**Comparison to Benchmarks.** The Trust's rates of return compare favorably to its benchmarks. A *benchmark* is a standard used for comparison when measuring investment performance and is typically a market index (e.g., Standard & Poor's 500 Index). As shown in **Figure 1**, in FY2003-FY2005, the performance of the Trust exceeded its benchmarks. In FY2006, the Trust's performance was slightly lower than its benchmarks. The Trust's performance is also comparable to that of defined benefit pension funds.<sup>12</sup>

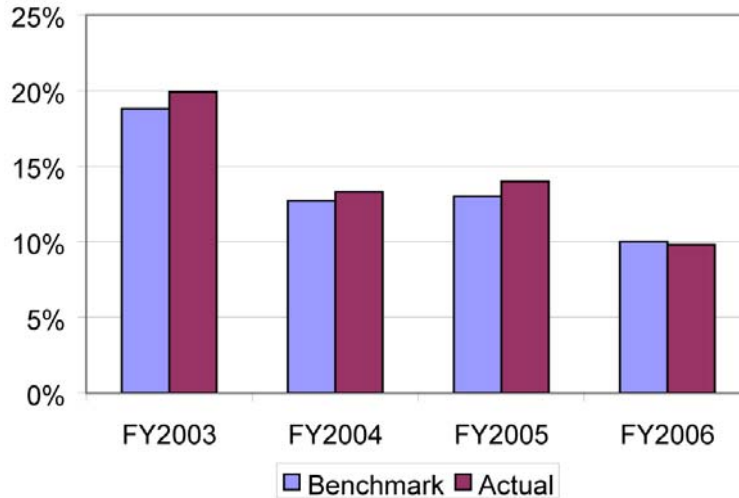
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<sup>10</sup> H.Rept. 107-082.

<sup>11</sup> NRRIT, *National Railroad Retirement Investment Trust Quarterly Update for the Period Ending September 30, 2007*, at [<http://www.rrb.gov/pdf/nrrit/qrtlyupd093007.pdf>].

<sup>12</sup> For example, the Milliman annual pension funding study shows the weighted average returns of 100 large defined benefit pension funds at private firms by *calendar* year (as opposed to fiscal year). Among this sample of firms, average annual returns were 19.2% in 2003, 13.3% in 2004, 14.0% in 2005, and 9.8% in 2006. (See Milliman, Inc., *2007 Pension Funding Study*, at [<http://www.milliman.com/expertise/employee-benefits/products-tools/pension-funding-study/index.php>].)

**Figure 1. Trust Rates of Return: Benchmarks Compared to Actual Returns**



**Source:** NRRIT, *National Railroad Retirement Investment Trust Annual Management Reports*, FY2003-FY2006.

**Administrative Expenses.** The Trust's administrative expenses have steadily increased as its investment portfolio has diversified over time, as shown in **Table 2**. However, administrative expenses remain very low compared to industry standards. In FY2006, the Trust's expense ratio was 15 basis points (i.e., expenses were 0.15% of average net assets).<sup>13</sup> In comparison, the average institutional investor paid an expense ratio of 66 basis points in 2006, more than four times higher than the Trust.<sup>14</sup>

**Table 2. Trust Expense Ratios, FY2003-FY2006**

Fiscal Year	Expense Ratio (%)
2006	0.15
2005	0.09
2004	0.04
2003	0.02

**Source:** NRRIT, *National Railroad Retirement Investment Trust Annual Management Reports*, FY2003-FY2006.

<sup>13</sup> NRRIT, *National Railroad Retirement Investment Trust Annual Management Report for Fiscal Year 2006*, at [<http://www.rrb.gov/pdf/nrrit/reportFY2006.pdf>].

<sup>14</sup> *Morningstar Fund Investor*, "Fund Fees Are Coming Down," May 21, 2007, by Russel Kinnel at [<http://ibd.morningstar.com/article/article.asp?CN=aol828&id=194298>].