H.R. 807, FEDERAL RESERVE BOARD RETIREMENT PORTABILITY ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON THE CIVIL SERVICE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

ON

H.R. 807

TO AMEND TITLE 5, UNITED STATES CODE, TO PROVIDE PORTABILITY OF SERVICE CREDIT FOR PERSONS WHO LEAVE EMPLOYMENT WITH THE FEDERAL RESERVE BOARD TO TAKE POSITIONS WITH OTHER GOVERNMENT AGENCIES

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CONTENTS

	Page
Hearing held on February 25, 1999	1
Text of H.R. 807	6
Statement of:	
Kelley, Edward W., Jr., Governor, Federal Reserve System; and William E. Flynn, III, Associate Director, Retirement and Insurance Services, Office of Personnel Management	13
Letters, statements, etc., submitted for the record by:	
Cummings, Hon. Elijah E., a Representative in Congress from the State of Maryland, prepared statement of	9
Flynn, William E., III, Associate Director, Retirement and Insurance Services, Office of Personnel Management:	
Information concerning portability	47
Prepared statement of	31
Kelley, Edward W., Jr., Governor, Federal Reserve System:	
Information concernign Thrift Savings Plans	51
Prepared statement of	16
Norton, Hon. Eleanor, a Representative in Congress from the District of Columbia, followup questions and responses	54
Scarborough, Hon. Joe, a Representative in Congress from the State of Florida, prepared statement of	3

H.R. 807, FEDERAL RESERVE BOARD RETIREMENT PORTABILITY ACT

THURSDAY, FEBRUARY 25, 1999

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON THE CIVIL SERVICE,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:37 a.m., in room 2247, Rayburn House Office Building, Hon. Joe Scarborough (chairman of the subcommittee) presiding.

Present: Representatives Scarborough, Morella, Cummings, and Norton.

Staff present: George Nesterczuk, staff director; Gary Ewing, counsel; John Cardarelli, clerk; Ned Lynch, senior research director; Jeff Shea, professional staff member; Tania Shand, minority professional staff member; and Jean Gosa, minority staff assistant.

Mr. SCARBOROUGH. Good morning. Let me begin by welcoming my colleagues to the first hearing of the Civil Service Subcommittee for the 106th Congress. Continuing their service on the subcommittee for the majority is the former chairman, Mr. Mica, and Mrs. Morella. The new members for the majority are Mr. Hutchinson, the gentleman from Arkansas, and Mr. Miller, my friend from the great State of Florida. For the minority, the ranking member is Mr. Cummings, who is continuing his service, as is the gentlelady, Ms. Norton. Mr. Allen of Maine is a new member on the minority side. I would like to welcome all the Members and look forward to a productive working relationship with my colleagues on the subcommittee.

Our jurisdiction is rather broad, covering pay and benefits for Federal workforce employees, and includes the rules for hiring, rewarding, and disciplining the employees. For those times when disputes arise or disciplinary actions are taken, a fairly elaborate appeals system has been established. This will also be falling in our jurisdiction.

As we deal with these matters, I want to assure everyone of my commitment to the principle that excellence in the workplace should be rewarded consistent with the contribution to public service. We do have a responsibility, as stewards of the public interest, to ensure that our investment in human capital provides effective service for the American people so that their hard-earned tax dollars are spent wisely.

We have already begun our work with the markup of H.R. 416, the Retirement Corrections bill, on February 3rd. I expect that bill will be taken to the floor of the House in the next few days. Next

month we will hold hearings on extending long-term care insurance benefits to Federal employees, and examine some additional employee benefit issues.

Today we are going to review the operation of two different pension systems within the Federal benefits structure. The examples before us compare a well-funded system, supported by long-term investments, with a system that has—for nearly 80 years—existed on a "pay-as-you-go" basis, with no substantial investment directed to the payment of future benefits.

Under current law, employees of the Federal Reserve System, which is a well-funded system, who might desire to continue their Federal service with other agencies, face portability problems. These barriers limit their ability to gain credit under the Federal Employment Retirement System for their service with the Federal Reserve Board. After this hearing we will mark up legislation that will finally remove this impediment to greater mobility in Federal agencies.

Because nearly 80 percent of the Fed's pension program is invested in a diversified portfolio of equities, it is thriving. Over the past 10 years it has averaged nearly a 16 percent annual return on investment, and the Fed has no unfunded liability. Instead, it has assets with an estimated value of more than $7 billion that enable it to provide a better benefit than FERS.

In contrast, the Civil Service Retirement and Disability Fund has reported unfunded liabilities exceeding $512 billion. While the market has thrived, the system has experienced declining interest rates on its holdings of Treasury securities. Even worse, because taxpayers must redeem both the principal and any interest attributed to these Treasury securities, each year Federal employees and annuitants face the specter of COLA delays, increased retirement deductions from their pay, or possible changes in the terms of their benefits—all traceable to the need to appropriate money to pay the accrued benefits.

These pressures are not accidental. They are a direct result of a design flaw that relies on future tax receipts to pay for growing retirement liabilities. The Federal Reserve's management of its retirement system demonstrates that it is possible to fund full benefits for employees without imposing a growing burden on future taxpayers.

[The prepared statement of Hon. Joe Scarborough follows:]

DAN BURTON, INDIANA
CHAIRMAN

ONE HUNDRED SIXTH CONGRESS

HENRY A. WAXMAN, CALIFORNIA
RANKING MINORITY MEMBER

Congress of the United States
House of Representatives
COMMITTEE ON GOVERNMENT REFORM
2157 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6143

Opening Remarks of the Honorable Joe Scarborough
Chairman, Civil Service Subcommittee

Hearing on Federal Reserve System Retirement Portability
February 25, 1999

Good morning. Let me begin by welcoming my colleagues to this first hearing of the Civil Service Subcommittee in the 106th Congress. Continuing their service on the Subcommittee for the Majority are former Chairman Mr. Mica, and Mrs. Morella. The new members for the Majority are Mr. Hutchinson, the gentleman from Arkansas, and Mr. Miller, my friend from the great State of Florida. For the Minority the Ranking Member, Mr. Cummings, is continuing his service, as is the Gentle lady Mrs. Norton. Mr. Allen of Maine is the new member from the other side. Again, welcome to all and I look forward to a productive working relationship with my colleagues on the Subcommittee.

Our jurisdiction is rather broad, covering pay and benefits for the federal workforce, and includes the rules for hiring, rewarding and disciplining the employees. For those times when disputes arise or disciplinary actions are taken, a fairly elaborate appeals system has been established. This, too, falls in our jurisdiction. As we deal with these matters, I want to assure everyone of my commitment to the principle that excellence in the workplace should be rewarded consistent with the contribution to public service. We have a responsibility, as stewards of the public interest, to ensure that our investment in human capital provides effective service for the American people, so that their hard-earned tax dollars are prudently spent.

We have already begun our work with the mark-up of H.R. 416, the retirement corrections bill, on February 3rd. I expect to take that bill to the floor of the House in the next few days. Next month, we will hold hearings on extending long term care insurance benefits for federal employees and examine some additional employee benefit issues.

Today, we will review the operation of two different pension systems within the federal benefit structure. The examples before us compare a well-funded system supported by long-term investments with a system that has, for nearly eighty years, existed on a pay-as-you-go basis, with no substantial investment directed to the payment of future benefits. Under current law, employees of the Federal Reserve System -- the well-funded system -- who might desire to continue their federal service with other agencies, face portability problems. These barriers limit their ability to gain credit under the Federal Employees Retirement System -- FERS -- for their service with the Fed. After this hearing, we will mark up legislation that will finally remove this impediment to greater mobility in federal agencies.

Because nearly 80 percent of the Fed's pension program is invested in a diversified portfolio of equities, it is thriving. Over the past ten years, it has averaged nearly 16 percent annual return on investment, and the Fed has no unfunded liability. Instead, it has assets with an estimated value of more than $7 billion that enable it to provide a better benefit than FERS.

In contrast, the Civil Service Retirement and Disability Fund (CSRDF) has reported unfunded liabilities exceeding $512 billion. While the market has thrived, the CSRDF has experienced declining interest rates on its holdings of Treasury securities. Even worse, because taxpayers must redeem both the principle and any interest attributed to these Treasury securities, each year federal employees and annuitants face the specter of COLA delays, increased retirement deductions from their pay, or possible changes in the terms of their benefits -- all traceable to the need to appropriate money to pay the accrued benefits.

These pressures are not accidental. They are a direct result of a design flaw that relies on future tax receipts to pay for growing retirement liabilities. The Federal Reserve's management of its retirement system demonstrates that it is possible to fund full benefits for employees without imposing a growing burden on future taxpayers. I look forward to our witnesses' discussions of the differences between these systems, and hope that we can gain some useful insights on managing the civil service retirement system more successfully.

###

Mr. SCARBOROUGH. I look forward to our witnesses' discussions on the differences between these systems, and I certainly hope that we can gain some useful insights on managing the Civil Service Retirement System more effectively and wisely.

Now I would like to turn it over to my ranking member and friend, Mr. Cummings, for any comments he may have.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

I want to congratulate you on your appointment, and I certainly look forward to working with you and all the other subcommittee members. I am glad that we are starting off this session with an issue that has bipartisan support.

Under current law, if an employee of the Federal Reserve Board leaves to work for another Federal agency, the employee is required to join FERS, the Federal Employees Retirement System. Under the current FERS statute, time spent working at the Board after 1988 does not count as "creditable service" toward a FERS annuity. Though they have not had a break in Federal service, affected employees will receive smaller pensions upon retirement.

This outcome resulted from an oversight that occurred when the FERS statute was written in the late 1980's. It affects Federal Reserve Board employees hired after 1983 who have worked at the Board after 1988. In human terms, the problem affects about 50 employees who have already left the Board for other agencies, and potentially affects about 1,000 people—about 60 percent of the Board's current workforce—should they move to other agencies and then retire under FERS. Over time, unless the problem is fixed, an even larger proportion of the Board's workforce will potentially be adversely affected.

It is worth noting that employees who come to work at the Board from other Federal agencies do not have a comparable problem, because the Board's retirement plan gives all Board employees full credit toward retirement for all their Government service.

H.R. 807 solves this problem of unequal treatment. It makes post-1988 Board service "creditable service" under FERS. As a result, affected employees will get the pensions they have earned, the pensions they should get—pensions that reflect all their Federal service. The employees, however, will have to give up any Board pension they would otherwise get and make a contribution to FERS to "buy" credit for the Board time. This quid pro quo is fair, prevents "double dipping," and ensures that those who benefit will be treated the same as other Federal employees under FERS.

The bill is similar to language in current law that addresses the same problem for Foreign Service employees. I understand that this legislation has been discussed with staff at OPM, who agree that there is a problem, that the problem should be fixed, and that this legislation does so appropriately.

[The text of H.R. 807 follows:]

106TH CONGRESS
1ST SESSION

H. R. 807

To amend title 5, United States Code, to provide portability of service credit for persons who leave employment with the Federal Reserve Board to take positions with other Government agencies.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 23, 1999

MR. SCARBOROUGH (for himself, Ms. NORTON, Mr. CUMMINGS, Mrs. Morella, Mr. HOYER, Mr. DAVIS of Virginia, Mr. MORAN of Virginia, Mr. WAXMAN, and Mr. MICA) introduced the following bill; which was referred to the Committee on Government Reform

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A BILL

To amend title 5, United States Code, to provide portability of service credit for persons who leave employment with the Federal Reserve Board to take positions with other Government agencies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Federal Reserve Board Retirement Portability Act".

SEC. 2. PORTABILITY OF SERVICE CREDIT.

(a) CREDITABLE SERVICE.—

(1) IN GENERAL.—Section 8411(b) of title 5, United States Code, is amended—

(A) by striking "and" at the end of paragraph (3);

(B) in paragraph (4)—

(i) by striking "of the preceding provisions" and inserting "other paragraph"; and

(ii) by striking the period at the end and inserting "; and"; and

(C) by adding at the end the following:

"(5) a period of service (other than any service under any other paragraph of this subsection, any military service, and any service performed in the employ of a Federal Reserve Bank) that was creditable under the Bank Plan (as defined in subsection (i)), if the employee waives credit for such service under the Bank Plan and makes a payment to the Fund equal to the amount that would have been deducted from pay under section 8422(a) had the employee been subject to this chapter during such period of service (together with interest on such amount computed under paragraphs (2) and (3) of section 8334(e)).

Paragraph (5) shall not apply in the case of any employee as to whom subsection (g) (or, to the extent subchapter III of chapter 83 is involved, section 8332(n)) otherwise applies.".

(2) BANK PLAN DEFINED.—Section 8411 of title 5, United States Code, is amended by adding at the end the following:

"(i) For purposes of subsection (b)(5), the term 'Bank Plan' means the benefit structure in which employees of the Board of Governors of the Federal Reserve System appointed on or after January 1, 1984, participate, which benefit structure is a component of the Retirement Plan for Employees of the Federal Reserve System, established under section 10 of the Federal Reserve Act (and any redesignated or successor version of such benefit structure, if so identified in writing by the Board of Governors of the Federal Reserve System for purposes of this chapter).".

(b) EXCLUSION FROM CHAPTER 84.—

(1) IN GENERAL.—Paragraph (2) of section 8402(b) of title 5, United States Code, is amended by striking the matter before subparagraph (B) and inserting the following:

"(2)(A) any employee or Member who has separated from the service after—

"(i) having been subject to—

"(I) subchapter III of chapter 83 of this title;

"(II) subchapter I of chapter 8 of title I of the Foreign Service Act of 1980; or

"(III) the benefit structure for employees of the Board of Governors of the Federal Reserve System appointed before January 1, 1984, that is a component of the Retirement Plan for Employees of the Federal Reserve System, established under section 10 of the Federal Reserve Act; and

"(ii) having completed—

"(I) at least 5 years of civilian service creditable under subchapter III of chapter 83 of this title;

"(II) at least 5 years of civilian service creditable under subchapter I of chapter 8 of title I of the Foreign Service Act of 1980; or

"(III) at least 5 years of civilian service (other than any service performed in the employ of a Federal Reserve Bank) creditable under the benefit structure for employees of the Board of Governors of the Federal Reserve System appointed before January 1, 1984, that is a component of the Retirement Plan for Employees of the Federal Reserve System, established under section 10 of the Federal Reserve Act,

determined without regard to any deposit or redeposit requirement under either such subchapter or benefit structure, or any requirement that the individual become subject to either such subchapter or benefit structure after performing the service involved; or".

(2) EXCEPTION.—Subsection (d) of section 8402 of title 5, United States Code, is amended to read as follows:

"(d) Paragraph (2) of subchapter (b) shall not apply to an individual who—

"(1) becomes subject to—

"(A) subchapter II of chapter 8 of title I of the Foreign Service Act of 1980 (relating to the Foreign Service Pension System) pursuant to an election; or

"(B) the benefit structure in which employees of the Board of Governors of the Federal Reserve system appointed on or after January 1, 1984, participate, which benefit structure is a component of the Retirement Plan for Employees of the Federal Reserve System, established under section 10 of the Federal Reserve Act (and any redesignated or successor version of such benefit structure, if so identified in writing by the Board of Governors of the Federal Reserve System for purposes of this chapter); and

"(2) subsequently enters a position in which, but for paragraph (2) of subsection (b), such individual would be subject to this chapter.".

(c) PROVISIONS RELATING TO CERTAIN FORMER EMPLOYEES.—A former employee of the Board of Governors of the Federal Reserve System who—

(1) has at least 5 years of civilian service (other than any service performed in the employ of a Federal Reserve Bank) creditable under the benefit structure for employees of the Board of Governors of the Federal Reserve System appointed before January 1, 1984, that is a component of the Retirement Plan for Employees of the Federal Reserve System, established under section 10 of the Federal Reserve Act;

(2) was subsequently employed subject to the benefit structure in which employees of the Board of Governors of the Federal Reserve System appointed on or after January 1, 1984, participate, which benefit structure is a component of the Retirement Plan for Employees of the Federal Reserve System, established under section 10 of the Federal Reserve Act (and any redesignated or successor version of such benefit structure, if so identified in writing by the Board of Governors of the Federal Reserve System for purposes of chapter 84 of title 5, United States Code); and

(3) after service described in paragraph (2), becomes subject to and thereafter entitled to benefits under chapter 84 of title 5, United States Code,

shall, for purposes of section 302 of the Federal Employees' Retirement System Act of 1986 (100 Stat. 601; 5 U.S.C. 8331 note) be considered to have become subject to chapter 84 of title 5, United States Code, pursuant to an election under section 301 of such Act.

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Subject to succeeding provisions of this subsection, this section and the amendments made by this section shall take effect on the date of enactment of this Act.

(2) PROVISIONS RELATING TO CREDITABILITY AND CERTAIN FORMER EMPLOYEES.—The amendments made by subsection (a) and the provisions of subsection (c) shall apply only to individuals who separate from service subject to chapter 84 of title 5, United States Code, on or after the date of enactment of this Act.

(3) PROVISIONS RELATING TO EXCLUSION FROM CHAPTER.—The amendments made by subsection (b) shall not apply to any former employee of the Board of Governors of the Federal Reserve System who, subsequent to his or her last period of service as an employee of the Board of Governors of the Federal Reserve System and prior to the date of enactment of this Act, became subject to subchapter III of chapter 83 or chapter 84 of title 5, United States Code, under the law in effect at the time of the individual's appointment.

Mr. CUMMINGS. I would caution against using this hearing to determine whether or not retirement fund assets should be invested in the private market. Investing retirement funds is a proposition that should be examined thoroughly with testimony from the administration, investment experts, and all other affected parties before any decision is made or action taken.

I thank the witnesses for coming today to testify and I look forward to the subcommittee taking swift action on the bill.

[The prepared statement of Hon. Elijah E. Cummings follows:]

OPENING STATEMENT OF THE HONORABLE ELIJAH E. CUMMINGS

RANKING MEMBER

SUBCOMMITTEE ON CIVIL SERVICE

HEARING ON

"Federal Reserve Board Retirement Portability Act"

Thursday, February 25, 1999

Mr. Chairman, this is the subcommittee's first hearing of the 106th Congress, and the first with you as our Chairman. Congratulations on your appointment. I look forward to working with you and all of the other subcommittee members. I am glad that we are starting off the session with an issue that has bipartisan support.

Under current law, if an employee of the Federal Reserve Board leaves to work for another federal agency, the employee is required to join FERS, the Federal Employees Retirement System. Under the current FERS statute, time spent working at the Board after 1988, does not count as "creditable service" towards a FERS annuity. Though they have not had a break in federal service, affected employees will receive smaller pensions upon retirement.

This outcome resulted from an oversight that occurred when the FERS statute was written in the late 1980's. It affects Federal Reserve Board employees hired after 1983 who have worked at the Board after 1988. In human terms, the problem affects about 50 employees who have already left the Board for other agencies, and potentially affects about 1000 people -- about 60% of the Board's current workforce -- should they move to other agencies and then retire under FERS. Over time, unless the problem is fixed, an ever-larger proportion of the Board's workforce will potentially be adversely affected.

It is worth noting that employees who come to work at the Board from other federal agencies do not have a comparable problem, because the Board's retirement plan gives all Board employees full credit toward retirement for all their government service.

H.R.807 solves this problem of unequal treatment. It makes post-1988 Board service "creditable service" under FERS. As a result, affected employees will get the pensions they have earned, the pensions they should get -- pensions that reflect *all* their federal service. The employees, however, will have to give up any Board pension they would otherwise get and make a contribution to FERS to "buy" credit for the Board time. This "quid pro quo" is fair, prevents "double dipping", and ensures that those who benefit will be treated the same as other

federal employees under FERS.

The bill is similar to language in current law that address the same problem for Foreign Service employees. I understand that this legislation has been discussed with staff at the Office of Personnel Management, who agree that there is a problem, that the problem should be fixed, and that this legislation does so appropriately.

I would caution against using this hearing to determine whether or not retirement fund assests should be invested in the private market. Investing retirement funds is a proposition that should be examined thorougly with testimony from the Administration, investment experts and all other affected parties, before any decision is made or action taken.

I thank the witnesses for coming today to testify and I look forward to the subcommittee taking swift action on the bill.

Mr. SCARBOROUGH. Thank you, Mr. Cummings.

Now I would like to recognize the gentlelady from the District of Columbia, who is a great friend of residents of this capital city, Ms. Norton.

Ms. NORTON. Thank you very much, Mr. Chairman.

I would like to thank our new chairman, Mr. Scarborough, and the ranking member, Mr. Cummings, for working together to bring this important issue before our subcommittee in such a timely fashion. I recognize that only 50 employees are now involved, but that number will accumulate, and for even 1 employee, this is a great burden and a burden that the employee should not have to bear at all because the oversight is ours. The legislation we take up today will cure that oversight, one created when we adopted the Federal Employees Retirement System.

Essentially what we do here is to ensure that the affected Board employees are able to carry retirement benefits to new positions within the Federal Government. If one of the affected employees transfers to another Federal agency, she begins to accrue retirement benefits under FERS as though she were a new Government employee.

The bill allows affected Board employees to transfer to another agency and elect to be treated as though previously serving the amount of time under the FERS program that she did under the Board retirement program.

This bill has particular importance for the Thrift Savings Plan, since the employee will be able to contribute to the plan and ultimately receive the amount she would have received had she otherwise been in the plan. Particularly today, when 368,000 Federal employees have been down-sized and another 300,000 civilian and military personnel are likely to be targeted for some kind of downsizing or privatization over the next 5 years, the ability to move to other Federal agencies without being penalized is fair and is essential.

I look forward to hearing from today's witnesses and to the continued bipartisan support that this committee brings to this issue today.

Thank you very much, Mr. Chairman.

Mr. SCARBOROUGH. Thank you, Ms. Norton.

Now I would like to ask our witnesses, since Government Reform is obviously an investigative committee, if you would stand up and take the oath before your testimony.

[Witnesses sworn.]

Mr. SCARBOROUGH. Thank you. Be seated.

Today we are honored to have the Honorable Edward Kelley with us, who is Governor of the Federal Reserve System, and we also have William Flynn, III, known as Ed Flynn, the Associate Director of Retirement and Insurance Services for OPM.

I would like to start with you, Mr. Kelley.

STATEMENTS OF EDWARD W. KELLEY, JR., GOVERNOR, FEDERAL RESERVE SYSTEM; AND WILLIAM E. FLYNN, III, ASSOCIATE DIRECTOR, RETIREMENT AND INSURANCE SERVICES, OFFICE OF PERSONNEL MANAGEMENT

Mr. KELLEY. Good morning and thank you, Mr. Chairman. I would like to request that my full statement be placed in the record of these hearings.

Mr. SCARBOROUGH. Without objection, so ordered.

Mr. KELLEY. Thank you.

Mr. Chairman, Representative Cummings, Representative Norton, I am pleased to testify on behalf of the Board of Governors on the Federal Reserve Board Retirement Portability Act, H.R. 807, and to provide the subcommittee with information on the Federal Reserve Retirement System.

The Board strongly supports this legislation. The bill would allow certain employees who leave the Board to work for other agencies and who then retire under the Federal Employees Retirement System, or FERS, to receive pensions reflecting all of their Federal service, which is not the case under current law. On behalf of the Board and its employees, let me particularly thank you, Mr. Chairman Scarborough, and Representatives Cummings, Morella, Mica, Waxman, Norton, Davis, Hoyer, and Moran for introducing this important legislation.

Quickly, by way of background, the Federal Reserve System has its own defined benefit retirement plan, composed of two parts: the Board Plan, covering Board employees hired before 1984—approximately 600 persons—and the Bank Plan, covering Board employees hired during and after 1984, and all employees of the Reserve Banks, in total about 24,000 persons.

Mr. Chairman, the first half of my prepared statement covered the material which the three of you all, in your opening remarks, have already covered. I think it would be redundant if I repeated that. You all stated the issue very effectively. It is very clear that you understand it quite well, and I greatly appreciate your careful attention to this issue, which you have evidenced by your opening remarks. I think I will just skip over discussing the issues of this bill because you have effectively summarized it in virtually the same terms in which I was going to attempt to do it.

Let me proceed, then, to respond briefly to the subcommittee's request for an overview of the Federal Reserve System Retirement Plan and information on the management of its pension plan assets.

The Federal Reserve System Retirement Plan is a defined benefit plan, qualified under Section 401(a) of the tax code, consisting of the two benefit structures mentioned a moment ago. The plan provides retirement benefits for virtually all employees of the Federal Reserve Board and the Federal Reserve Banks. The Federal Reserve Banks and the Board, as employers, are responsible to ensure the funding required to pay the benefits promised to participants, and have contributed to the plan at varying levels as determined necessary by the Plan Actuary.

Since 1986, the Actuary has determined that no employer contributions are required, and currently the retirement plan's assets exceed both the plan's accrued liability, as well as its total liability.

Plan assets based on a 5-year moving average as of January 1, 1998, were $4 billion, while the current value of plan assets at the end of 1998 was $5.8 billion. The total benefit obligation as of January 1, 1998, which includes both past and future service and future salary increases, was $3.5 billion, while benefits actually accrued to date were valued at $2.8 billion.

The Federal Reserve Thrift Plan is the System's defined contribution savings plan, comparable to the Government's Thrift Savings Plan [TSP]. The Federal Reserve Thrift Plan differs from TSP in that it offers both pre-tax and after-tax savings components, a wider variety of investment options, and allows higher contribution rates—up to 20 percent of salary, subject to IRS limitations.

The Federal Reserve System places fiduciary responsibility for the investment of both its defined benefit and defined contribution savings plans in a committee of five senior System officers. This oversight committee is currently comprised of three Federal Reserve Bank presidents, one member of the Board—and I serve in that capacity at this time—and the first vice president of the New York Reserve Bank. At the end of 1998, the pension and savings plans had investments valued at $8.1 billion, with $5.8 billion of that representing the pension plan assets.

Our oversight committee distances itself from asset allocation and security selection decisions to avoid the appearance of a conflict of interest with the System. Instead, the committee functions as a "manager of managers," selecting independent investment firms and giving them a common, balanced investment mandate, as set forth in our investment objectives and guidelines document, a copy of which has been provided to the subcommittee. This document is part of our investment advisory agreement with each firm, and delegates to them asset allocation decisions within broad parameters set by the committee, security selection, and the voting of proxies.

Currently, eight firms are retained to manage our pension assets, of which about two-thirds were invested in equities as of year's end. I believe, Mr. Chairman, that you may have mentioned that 80 percent of our funds were invested in equities; it is actually about 65 or 66 percent, rather than the maximum allowable percentage of 80 percent.

Managers are selected by written criteria that include past performance, desired equity and fixed income investment styles, trading and research capabilities, expense levels, and so forth. Management expenses for the entire plan are less than one-quarter of 1 percent of invested assets. A small staff in New York monitors portfolio activity and performance, reporting on both to the committee on a monthly basis.

Performance of invested assets is measured against three benchmarks: first, versus the expected long-term rate of return for plan investments used in actuarial evaluation, which is currently 9 percent; second, versus a trailing 36-month composite return index; and third, in comparison to the plan's peer group in the Wilshire Trust Universe Comparison Service.

I am pleased to be able to report that the plan has met or exceeded each of those benchmarks over many years.

Thank you, Mr. Chairman. I would be pleased to attempt to answer any questions that the committee may have.

[The prepared statement of Mr. Kelley follows:]

For release on delivery
10:00 a.m. E.S.T.
February 25, 1999

Statement by

Edward W. Kelley, Jr.

Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Civil Service

House of Representatives

February 25, 1999

Mr. Chairman, Representative Cummings, members of the Subcommittee, I am pleased to testify on behalf of the Board of Governors on the Federal Reserve Board Retirement Portability Act, and to provide the Subcommittee with information on the Federal Reserve retirement system. The Board strongly supports this legislation. The bill would allow certain employees who leave the Board to work for other agencies and who then retire under the Federal Employees Retirement System (FERS), to receive pensions reflecting all of their federal service, including post-1988 service at the Federal Reserve Board. On behalf of the Board and its employees, let me particularly thank you, Chairman Scarborough, and Representatives Cummings, Morella, Mica, Waxman, Norton, Davis, Hoyer, and Moran for introducing this important legislation.

By way of background, the Federal Reserve System has its own defined benefit retirement plan which has two benefit structures: the Board Plan covering Board employees hired pre-1984 which is modeled on the Civil Service Retirement System (CSRS); and the Bank Plan, covering Board employees hired after 1983 and all employees of the Federal Reserve Banks. The Board Plan and CSRS have historically had reciprocity with regard to service credit portability. However, as a result of an oversight that occurred when the FERS statute was first passed, post-1988 service at the Federal Reserve Board by employees enrolled in the Bank Plan and, in some limited situations, those enrolled in the Board Plan, is not creditable service under FERS.

Service Credit Problem

The Board gains and loses employees in transfers between the Board and other government agencies each year. In particular, transfers between the Board and the other

bank regulatory agencies -- the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision -- are common. The Board grants credit under its retirement plan to newly-hired employees with prior CSRS and FERS service if the employee renounces benefits under the prior retirement plan (to prevent dual credit). Thus, there is service portability when employees come to the Board. And, generally, there has been portability between the Board and other government agencies in crediting Board Plan service under CSRS. However, due to the oversight mentioned above, post-1988 Bank Plan service at the Federal Reserve Board is not creditable under FERS.

As a result, if a Board employee hired after 1983 (and participating in the Bank Plan) leaves the Board to work for another federal agency and then retires from that agency under FERS, that employee would receive a reduced pension that would not reflect all of that employee's federal government service. This problem also affects any employee who participated in the Board Plan, did not complete five years of service prior to 1987, and left the Board and reentered federal employment after a break in service of more than one year. In this situation, under current law, the employee would be placed under FERS with no credit for post-1988 Board service. My testimony will refer to these situations as the "service credit" problem.

Under current law, an employee affected by the service credit problem could receive two pensions: the reduced pension from FERS and, if he or she had worked long enough to be vested, a pension from the Board. In this case, because of the way the

pensions are calculated, the sum of those pensions would usually be less than a single FERS pension that gave credit for all of the individual's federal government service. Alternatively, if the employee was not vested at the Board, he or she would receive only the reduced FERS pension.

Thus, current law creates a dollars-and-cents problem in retirement security. Depending on the individual's final average salary and years of other federal service, the lack of portability of post-1988 Board service can mean the loss of hundreds or thousands of dollars a year in retirement income.

We have identified about fifty former employees of the Board who have gone to work for other federal agencies and who will have this service credit problem when they retire under FERS. In addition, those of the Board's current workforce covered by the Bank Plan (about two-thirds of staff) would have the same problem if they should go to another federal agency and retire under FERS. Over time, a growing percentage of Board staff could encounter similar problems since virtually all new hires will have service that is not creditable under FERS.

The service credit problem has festered without resolution since the FERS statute was enacted in 1986. Employees at the Board are very aware of it. The problem is damaging to employee morale and, just as important, some Board employees are deterred from making sound career moves because their pensions will suffer. And, government agencies' efforts to recruit these employees are hampered.

The bill before the Subcommittee would correct the unidirectional service credit problem. It would amend the FERS statute to make post-1988 Board service creditable service under FERS. As a result, when affected former Board employees retire under FERS, their pensions will reflect all their federal government service.

To receive credit for post-1988 Board service under FERS, the bill appropriately requires the employee to do two things. First, the employee would have to renounce the entitlement (if any) to receive a pension from the Board. This would prevent receipt of credit for post-1988 Board service under both FERS and the Bank Plan.

Second, the bill requires the employee to make a contribution to FERS that, in effect, would "buy" FERS credit for his or her Board service. This contribution would equal the amount the employee would have contributed to FERS if he or she had been covered by FERS during the service in question, plus interest to the date of payment. This contribution is appropriate, since all FERS participants are required to contribute toward their pension benefit.

These two requirements mirror provisions in current law that provide service credit for employees with prior service under the Foreign Service pension program.

We believe that virtually all affected employees would be better off with this legislation than under current law. This includes the Bank Plan employee who transfers to another agency and is placed under FERS, as well as the Board Plan employee with less than five years service prior to 1987 who was placed under FERS following a break in service of more than one year. As FERS employees, they will receive service credit for

their post-1988 Board service. Future government hires in the second situation (prior Board Plan) would be placed in CSRS Offset as a result of the legislation, where their post-1988 Board service would be creditable.

To ensure that no one is inadvertently hurt, the bill would, in effect, allow affected employees to choose whether or not to get FERS credit for their post-1988 Board service. With that option, the employee could make whichever choice would be more advantageous.

In conclusion, Mr. Chairman, the Board and its employees strongly support this legislation, and we hope that the Congress can approve it quickly.

I would now like to respond to the Subcommittee's request for an overview of the Federal Reserve Retirement Plan and information on the management of pension plan assets.

Overview of the Federal Reserve Retirement Plan

The Federal Reserve System Retirement Plan is a governmental defined benefit plan that is qualified under Section 401(a) of the tax code. The Plan provides retirement benefits for virtually all employees of the Federal Reserve Board and Reserve Banks. (Exceptions are approximately 30 employees at the Board who are in FERS or CSRS.) Plan benefits are determined under two separate benefit structures: the Board Benefit Structure (Board Plan), which covers approximately 600 Board employees; or the Bank Plan, which covers all eligible Reserve Bank staff (about 23,000 employees) and approximately 1,000 Board employees. There are approximately 500 annuitants receiving

payments from the Board Plan and approximately 12,000 annuitants receiving payments from the Bank Plan, with another 5,000 who have earned a benefit but have not yet begun drawing payments.

The Federal Reserve Banks and the Board, as employers, are responsible to ensure the funding required to pay the benefits promised to participants and have contributed to the Plan at varying levels throughout the years as determined necessary by the Plan actuary. Since 1986, the actuary has determined that no employer contributions are required. Currently, the Retirement Plan's assets exceed both the Plan's accrued liability as well as total liability as calculated by the Plan actuary. Plan assets based on a 5-year moving average as of January 1, 1998, were $4.0 billion. The total benefit obligation--which includes both future service and future salary increases--was $3.5 billion. Accrued benefits--based on service and salary up to the date of the valuation--were valued at $2.8 billion. The value of Plan assets at the end of 1998 was $5.8 billion.

The Board Plan covers Board employees hired prior to 1984; its plan design is nearly identical to that of the Civil Service Retirement System. Participants do not pay Social Security tax, but have contributed to the Board Plan at the same rate as CSRS participants over the years (except that the Board did not increase the employee contribution rate from 7.0 percent to 7.25 percent in 1999 as CSRS did). The benefit features of the Board Plan mirror those of CSRS in most important respects. The most significant differences are: the Board Plan credits Federal Reserve Bank service while CSRS does not; the Board Plan has adopted a benefit formula for employees with part-

time service after April 6, 1986, that is different from the CSRS; and the Board Plan does not allow incorporation of retired military pay into the Board Plan annuity as allowed by CSRS. A detailed listing of the differences between the two plans is found in Attachment A.

The Bank Plan covers all eligible employees of the Federal Reserve Banks. When Congress passed legislation requiring that federal employees hired after 1983 be subject to Social Security tax, the Board decided to place all newly hired Board employees in the Bank Plan as well. Unlike the Board Plan, the Bank Plan does not require employee contributions, but all Bank Plan participants are covered under Social Security and thus are subject to the FICA withholding requirement. The basic annuity formula for the Bank Plan is integrated with Social Security. The annuity formula is based on years of creditable service and the average of the five highest earning years of the employee's career. The benefit formula provides 1.3 percent of High-5 salary up to the Social Security integration level times the number of years of creditable service plus 1.8 percent of High-5 salary above the integration level times years of creditable service.

While the Bank Plan is similar to FERS in that it is designed to work together with Social Security, the plan design features differ. For example, the Bank Plan requires no employee contributions as FERS does; it uses the highest five years of earnings to compute the pension benefit rather than the highest three years under FERS; and it provides for annuity reductions for retirements prior to age 60 while FERS allows unreduced retirement below age 60 if the participant has 30 years of service. A detailed

comparison of the plan features of FERS and the Bank Plan are provided in Attachment B.

The Federal Reserve Thrift Plan is the System's defined contribution plan comparable to the government's Thrift Savings Plan (TSP). Both Board Plan and Bank Plan employees are eligible to participate and receive employer matching funds. The Federal Reserve Thrift Plan differs from TSP in that it offers both pre-tax and after-tax savings components, and a wider variety of investment options. It also allows higher contribution rates from participants (up to 20 percent of salary), subject to IRS limitations.

Management of Pension Plan Assets

The Federal Reserve System, composed of the Board of Governors and 12 Reserve Banks, vests fiduciary responsibility for the investments of its defined benefit (pension) and defined contribution (savings) plans in a committee of five senior System officers. The System's investment oversight committee is currently comprised of three Reserve Bank presidents, one Member of the Board, and the First Vice President of the New York Reserve Bank. The pension and savings Plans had investments valued at $8.1 billion as of year-end 1998, with $5.8 billion representing pension plan assets.
I represent the Board on this committee and have done so since 1994. The committee is chaired by one of the Reserve Bank presidents (currently Mr. Gary Stern of the Minneapolis Reserve Bank). Day-to-day oversight of the investments is the responsibility of a small staff (3) in New York directed by our Chief Investment Officer, Mr. Paul Lipson, CFA.

Our oversight committee has long sought to distance itself from asset allocation decisions because such activity might bring with it the appearance of a conflict of interest for the System. Instead, the committee functions as a manager-of-managers -- selecting independent investment firms and giving them a common balanced investment mandate. That mandate is set forth in our *Investment Objectives and Guidelines* document, which has been provided to the Subcommittee. This document is part of the investment advisory agreement with each firm, and delegates to them asset allocation decisions (within broad parameters set by the committee), securities selection decisions, and the voting of proxies.

Currently, eight firms are retained to manage our $5.8 billion in pension assets (of which about two-thirds were invested in equities as of year end 1998). Those balanced accounts range in size from $350 million to $1 billion. Managers are selected by criteria that include past performance, desired equity and fixed income investment "styles", trading and research capabilities, expense levels, etc. Management expenses for the entire Plan are less than one-quarter of one percent of invested assets. No pension assets are managed in-house. The staff in New York monitors portfolio activity and performance, reporting on both to the committee on a monthly basis. The committee meets with its portfolio managers at least once a year; staff meets with most of them quarterly. No consultants are retained for any aspect of the investment process; although the staff in New York makes extensive use of generally-available analytical software to assess returns and various measures of risk.

Performance of invested assets is measured against three benchmarks: *versus* the expected long term rate of return for Plan investments used in actuarial valuation (currently 9%), *versus* a trailing 36 month composite return (60% S&P 500/40% Lehman Bros. Aggregate), and *in comparison to* the Plan's peer group in the Wilshire Trust Universe Comparison Service, the largest tax-exempt institutional performance database in the US. I am pleased to report that the Plan has met or exceeded each of those benchmarks over many years.

Attachment A

DIFFERENCES BETWEEN CSRS AND BOARD PLAN

The Board Plan and CSRS are identical in major benefit provisions. The few differences that exist include the following.

1. Board Plan provides credit for service performed at Federal Reserve Banks, subject to deposit rules for non-contributory service. CSRS does not permit credit for Federal Reserve Bank service unless the CSRS participant is a presidential appointee.

2. The Board Plan does not permit military retirement pay to be waived and credit received for such time under the Board Plan. CSRS permits such credit upon waiver of military retired pay.

3. The Board Plan does not include the requirement under CSRS that a participant must have at least one year of civilian service under CSRS within the two years immediately prior to the retirement date.

4. The Board Plan has amended the provisions for determining the retirement benefit for employees who had part-time service after 4/6/86. The change corrects some inequities that exist under the CSRS treatment of part-time employees. The change is consistent with a provision to amend CSRS that was introduced in legislation proposed by Senator Robb in the 105th Congress.

5. Entitlement to Discontinued Service Retirement under the Board Plan is determined by the Board pursuant to a resolution. CSRS has specific requirements promulgated by OPM for discontinued service retirements.

6. The employee contribution rate under the Board Plan varies from the employee contribution rate under CSRS for the first time, effective January 1999. The Board Plan rate continues to be 7 percent; the CSRS rate rose to 7.25 percent.

7. The Board benefit structure does not include certain special provisions provided for under CSRS such as: special provisions for firefighters, law enforcement officers, air traffic controllers, employees on LWOP to serve in an employee organization, employees temporarily assigned to a state or local government, and similar situations.

8. Board Plan annuitants are treated differently upon reemployment. Under CSRS, the reemployed annuitant continues to receive an annuity but is paid a salary that is reduced by the amount of that annuity. Board Plan annuitants have the annuity suspended until the period of reemployment has ended.

Attachment B

RETIREMENT SYSTEM COMPARISON

	BANK PLAN	FERS
Retirement Eligibility B Unreduced Benefit	Age 65 with 5 yrs service Age 60 & meets rule of 90 (age + service = 90)	Age 62 with 5 yrs service Age 60 with 20 yrs service MRA(age 55 to age 57 depending on birthdate) + 30 yrs service
Retirement Eligibility B Reduced Benefit	Minimum: Age 50 w/ 5 yrs (37.5 percent of full benefit) Reductions based on actuarial tables	MRA + 10 years service (5 percent reduction for each year under age 62)
Retirement Computation Formula	1.3 percent x High-5 average salary up to SS Integration level, plus 1.8 percent x High-5 average salary over SS integration level, multiplied by total years of service Reduction for retirement before eligibility date (based on actuarial table) Maximum annuity B 80 percent of High-5 average salary	1 percent (or 1.1 percent at age 62) x High-3 salary x total years of service plus annuity supplement, where applicable Reduction of 5 percent for each year under age 62 No maximum annuity
Cost of Living Adjustments	Upon approval of Board of Governors B On average, 40 B 60 percent of CPI-W change after CPI-W increases at least 8 percent	No COLAs until age 62; CPI-1 thereafter
Employee Contributions	None required Social Security contributions	Currently 1.05 percent + Social Security Contributions
Employer Contributions	None since 1986 Social Security Contributions	Currently 10.7 percent + Social Security Contributions
Vesting	5 years	5 years

Mr. SCARBOROUGH. Thank you, Mr. Kelley. We appreciate it.

Mr. Flynn.

Mr. FLYNN. Mr. Chairman, good morning. I want to thank you and members of the subcommittee for inviting us to testify today to discuss the Federal Reserve Board's service credit proposal. The Board's proposal would make service credit available under the Federal Employees Retirement System for post-1988 Board service covered by its retirement system.

Very briefly, in setting a context for today's hearing, I point out that very few Federal employees are covered under retirement systems other than the Civil Service and Federal Employees Retirement System. With that in mind, providing credit under the Federal Employees Retirement System for employment with the Federal Reserve Board is, we believe, warranted. To the degree that participants or sponsors of other plans may seek service credit in a similar fashion, we think it makes sense to examine each of them on their own merits.

Now, generally, under the old Civil Service Retirement System, all periods of service as a Federal employee under Title 5 can be used for retirement purposes, but only under a single retirement system. When the Federal Employees Retirement System was created, it was designed as a fully funded system, paid for by employer and employee contributions. Following a transition period that ended at the end of 1988, service credit for civilian employment is available only for service that was covered under the system at the time that it was performed.

The original Federal Employees Retirement System Act did, however, include one exception. It provided service credit for post-1988 non-covered service performed under the Foreign Service Retirement System, and under that exception a former Foreign Service employee waives credit under the Foreign Service System and pays a deposit equal to the contributions, with interest, he or she would have made to the Federal Employees Retirement System. Credit may be similarly transferred by an employee between retirement systems in the opposite direction.

Now, by statute, there are no explicit funding provisions for these transfers covering employer contributions to the respective systems. The provisions work because there is reciprocity between the two systems. Since credit goes both ways, the effect is to offset the cost of credit by savings from service transfers.

Now, there is no evidence that this mechanism for the Foreign Service was created exclusively for that system, so it is likely that the lack of similar provisions for Title 5 service in other retirement systems was inadvertent.

Historically, transfers of employees between Title 5 employment and the Federal Reserve Board have been common. After 1988, however, the Board found that individuals were reluctant to transfer because they knew that the time could not be credited if and when they returned to Title 5 employment. Accordingly, we worked closely with the Board's staff to create the proposal before you today. In terms of both policy and funding, it was logical to provide for service credit on the same basis as for Foreign Service employment.

We believe it is a good bill that provides a reasonable solution to the matter.

Mr. Chairman, your invitation also posed several questions related to funding of the Government's retirement systems. In particular, your letter asks whether there are other Federal retirement systems invested in equities, and what the state of their funding is.

The GAO report from 1996, mentioned in your letter, offers an answer to that question. While the figures could be updated, the investment placement in unfunded liabilities of all the retirement systems are in the appendix to that report.

In the balance of your invitation letter, Mr. Chairman, you asked several additional questions relating to projected performance of the Retirement and Disability Fund under scenarios that envision investment of all or a portion of its assets in private securities. As you know, administration of the Civil Service and Federal Employees Retirement Systems and the Retirement and Disability Fund itself are matters that are governed by statute. As such, they reflect a broad consensus based on policy conclusions that have been ratified by Congress and the administration over many decades. Indeed, the creation of the Federal Employees Retirement System and the Thrift Savings Plan reflect the evolution of that consensus. The Federal Employees Retirement System explicitly recognizes that private savings can and do play an important and beneficial role in achieving income security in retirement. That system crafts a balance between the security of a defined benefit and the risks associated with private investment.

The bottom line is that investment of retirement fund assets is an important and complex matter. We should be willing to regularly review those policies, but changes should be made only after careful and circumspect review, taking into consideration the views of all interested parties and mindful of the potential for profound budgetary and economic consequences from such changes.

As just one example of that, I call the subcommittee's attention to the testimony of Mr. James Blum, referenced in your letter of invitation. His testimony from 1997 included a broad review of the policy issues associated with financing the Federal Government's retirement systems. He pointed out the consequences, both negative and positive, of varying approaches to funding retirement benefits, and those consequences remain as valid today as they were then.

Mr. Chairman, that concludes my statement, and I would be happy to answer any questions you or other members of the subcommittee may have.

[The prepared statement of Mr. Flynn follows:]

STATEMENT OF
WILLIAM E. FLYNN, III, ASSOCIATE DIRECTOR
FOR RETIREMENT AND INSURANCE
OFFICE OF PERSONNEL MANAGEMENT

at a hearing of the

CIVIL SERVICE SUBCOMMITTEE
COMMITTEE ON GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES

ON

ISSUES RELATED TO FEDERAL EMPLOYEES' RETIREMENT BENEFITS

FEBRUARY 25, 1999

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

I AM PLEASED TO APPEAR TODAY TO DISCUSS THE FEDERAL RESERVE BOARD'S SERVICE CREDIT PROPOSAL. THE BOARD'S PROPOSAL WOULD MAKE SERVICE CREDIT AVAILABLE UNDER THE FEDERAL EMPLOYEES' RETIREMENT SYSTEM FOR POST-1988 BOARD SERVICE COVERED BY ITS RETIREMENT SYSTEM.

IN SETTING A CONTEXT FOR THIS HEARING, YOUR INVITATION LETTER REFERRED TO A 1996 GAO REPORT, CONCERNING FEDERAL RETIREMENT SYSTEMS. IN THAT REPORT, THE GAO STATED THAT MORE THAN 10

MILLION INDIVIDUALS ARE ENROLLED IN 34 DEFINED BENEFIT PLANS, AND ANOTHER 2.2 MILLION INDIVIDUALS ARE ENROLLED IN 17 DEFINED CONTRIBUTION PLANS.

FIRST, NEARLY HALF OF THESE INDIVIDUALS ARE ENROLLED IN THE MILITARY RETIREMENT SYSTEM. WHILE IT IS A FEDERAL RETIREMENT SYSTEM, IT IS, AS ITS NAME IMPLIES, NOT A CIVILIAN RETIREMENT PROGRAM FOR FEDERAL EMPLOYEES, BUT RATHER A RETIREMENT PLAN FOR UNIFORMED MEMBERS OF THE MILITARY SERVICES.

OF THE REMAINING PARTICIPANTS IN FEDERAL RETIREMENT PLANS, THE OVERWHELMING MAJORITY OF THE DEFINED BENEFIT PARTICIPANTS ARE MEMBERS OF EITHER THE CIVIL SERVICE OR FEDERAL EMPLOYEES' RETIREMENT SYSTEMS. IN ADDITION, ACCORDING TO THE GAO, 97 PERCENT OF THE DEFINED CONTRIBUTION PARTICIPANTS ARE ENROLLED IN THE THRIFT SAVINGS PLAN.

THE REMAINING PLANS, SMALL IN NUMBERS OF PARTICIPANTS, ARE LARGELY SPECIAL RETIREMENT PLANS FOR FEDERAL JUDGES, NON-APPROPRIATED FUND EMPLOYEES AND PRIVATE SECTOR EMPLOYEES OF

THE FARM CREDIT SYSTEM.

AS YOU CAN SEE, THE REALITY IS THAT THE FEDERAL RETIREMENT ENVIRONMENT IS MOSTLY UNITARY, AND VERY FEW FEDERAL EMPLOYEES ARE COVERED UNDER RETIREMENT SYSTEMS OTHER THAN THE CIVIL SERVICE AND FEDERAL EMPLOYEES' RETIREMENT SYSTEMS. IN THAT CONTEXT, FEDERAL EMPLOYEES' RETIREMENT SYSTEM CREDIT FOR FEDERAL SERVICE WITH THE FEDERAL RESERVE SYSTEM, IS, WE BELIEVE, WARRANTED. TO THE DEGREE THAT PARTICIPANTS OR SPONSORS OF OTHER PLANS MAY SEEK SERVICE CREDIT, THE NUMBERS ARE SMALL ENOUGH TO JUSTIFY EXAMINING EACH PLAN INDIVIDUALLY, ON THEIR OWN MERITS AND IN CONSIDERATION OF THE POLICY OBJECTIVES EACH MIGHT SEEK TO SERVE.

TURNING TO THE FEDERAL RESERVE BOARD'S PROPOSAL, I WOULD LIKE TO BRIEFLY DISCUSS THE OVERALL SITUATION OF SERVICE CREDIT FOR RETIREMENT PURPOSES. GENERALLY, UNDER THE OLDER CIVIL SERVICE RETIREMENT SYSTEM, ALL PERIODS OF SERVICE AS A FEDERAL EMPLOYEE UNDER TITLE 5 CAN BE USED FOR RETIREMENT PURPOSES, BUT ONLY UNDER A SINGLE RETIREMENT SYSTEM.

WHEN THE FEDERAL EMPLOYEES' RETIREMENT SYSTEM WAS CREATED, IT WAS DESIGNED AS A FULLY FUNDED SYSTEM, PAID FOR BY EMPLOYER AND EMPLOYEE CONTRIBUTIONS. FOLLOWING A TRANSITION PERIOD THAT ENDED DECEMBER 31, 1988, SERVICE CREDIT FOR CIVILIAN EMPLOYMENT IS AVAILABLE ONLY FOR SERVICE THAT WAS COVERED UNDER THE SYSTEM AT THE TIME IT WAS PERFORMED.

THE ORIGINAL FEDERAL EMPLOYEES' RETIREMENT SYSTEM ACT DID, HOWEVER, INCLUDE ONE EXCEPTION. IT PROVIDED SERVICE CREDIT FOR POST-1988 NON-COVERED SERVICE PERFORMED UNDER THE FOREIGN SERVICE RETIREMENT SYSTEM.

UNDER THAT EXCEPTION, A FORMER FOREIGN SERVICE EMPLOYEE DESIRING CREDIT UNDER THE FEDERAL EMPLOYEES' RETIREMENT SYSTEM WAIVES CREDIT UNDER THE FOREIGN SERVICE SYSTEM AND PAYS A DEPOSIT EQUAL TO THE CONTRIBUTIONS, WITH INTEREST, HE OR SHE WOULD HAVE MADE TO THE FEDERAL EMPLOYEES' RETIREMENT SYSTEM. CREDIT MAY BE SIMILARLY TRANSFERRED BY AN EMPLOYEE BETWEEN RETIREMENT SYSTEMS IN THE OPPOSITE DIRECTION.

BY STATUTE, THERE ARE NO EXPLICIT FUNDING PROVISIONS FOR THESE TRANSFERS COVERING EMPLOYER CONTRIBUTIONS TO THE RESPECTIVE RETIREMENT SYSTEMS. THE PROVISIONS WORK BECAUSE THERE IS A RELATIVE EVENNESS IN THE RECIPROCITY OF TRANSFERS OF EMPLOYEES BETWEEN THE TWO SYSTEMS. AS LONG AS THE TRANSFERS DO NOT BECOME A ONE-WAY STREET, THE FINANCIAL RESULT IS NEUTRAL. BECAUSE THERE IS RECIPROCITY AND CREDIT GOES BOTH WAYS, THE EFFECT IS TO OFFSET THE COST OF CREDIT BY SAVINGS FROM SERVICE TRANSFERRED.

THERE IS NO EXPLANATION IN THE LEGISLATIVE HISTORY SHEDDING LIGHT ON THE QUESTION OF WHY THE ORIGINAL FEDERAL EMPLOYEES' RETIREMENT SYSTEM ACT PERMITTED TRANSFER OF SERVICE CREDIT FROM THE FOREIGN SERVICE SYSTEM, BUT NOT FROM OTHER FEDERAL RETIREMENT SYSTEMS. ONE LIKELY POSSIBILITY IS THAT SINCE THE FOREIGN SERVICE SYSTEM WAS BEING REFORMED BY THE CONGRESS AT THE SAME TIME, THE LACK OF A PROVISION FOR TITLE 5 SERVICE COVERED BY OTHER FEDERAL RETIREMENT SYSTEMS WAS AN INADVERTENT OVERSIGHT.

IN ANY EVENT, THE FEDERAL RESERVE BOARD CAME TO US SOME TIME AGO, NOTING THAT THE FAILURE TO PROVIDE SERVICE CREDIT FOR POST-1988 BOARD SERVICE WAS A PROBLEM. HISTORICALLY, TRANSFERS OF EMPLOYEES BETWEEN TITLE 5 EMPLOYMENT AND BOARD EMPLOYMENT HAVE BEEN COMMON. OUR UNDERSTANDING IS THAT AFTER 1988, THE BOARD FOUND THAT INDIVIDUALS WERE RELUCTANT TO LEAVE TITLE 5 EMPLOYMENT TO WORK FOR THE BOARD IF THEY KNEW THE TIME COULD NOT BE CREDITED WHEN THEY RETURNED TO TITLE 5 EMPLOYMENT. NO OTHER ORGANIZATION WITH A SEPARATE RETIREMENT SYSTEM FOR FEDERAL EMPLOYEES HAS COME TO US WITH SIMILAR CONCERNS.

ACCORDINGLY, WE WORKED CLOSELY WITH BOARD STAFF TO CREATE THE PROPOSAL BEFORE YOU TODAY. IN TERMS OF BOTH POLICY AND FUNDING, IT WAS LOGICAL TO PROVIDE FOR SERVICE CREDIT ON THE SAME BASIS AS FOR FOREIGN SERVICE EMPLOYMENT. AS WITH THE FOREIGN SERVICE SYSTEM, THERE HAS BEEN A RELATIVE EVENNESS IN THE RECIPROCITY OF TRANSFERS BETWEEN TITLE 5 AGENCIES AND THE BOARD, WHICH WE WOULD EXPECT TO CONTINUE IF THIS LEGISLATION WERE TO BE ENACTED. THUS, WE WOULD EXPECT THERE TO BE AN

OFFSET OF THE COST OF CREDIT BY SAVINGS FROM THE SERVICE TRANSFERRED. THE BILL ALSO ADDRESSES RELATED ISSUES DEALING WITH RETIREMENT SYSTEM COVERAGE FOR EMPLOYEES COMING FROM BOARD EMPLOYMENT TO TITLE 5 EMPLOYMENT. WE BELIEVE IT IS A GOOD BILL THAT PROVIDES A REASONABLE SOLUTION TO THIS MATTER.

YOUR INVITATION ALSO POSED SEVERAL QUESTIONS RELATED TO FUNDING OF THE GOVERNMENT'S RETIREMENT SYSTEMS. IN PARTICULAR, YOUR LETTER ASKS WHETHER THERE ARE OTHER FEDERAL RETIREMENT SYSTEMS INVESTED IN EQUITIES, AND WHAT THE STATE OF THEIR FUNDING IS. I WOULD CALL YOUR ATTENTION TO THE GAO REPORT FOR AN ANSWER TO THAT QUESTION. WHILE THE FIGURES COULD BE UPDATED, THE INVESTMENT PLACEMENT AND UNFUNDED LIABILITIES OF ALL OF THE RETIREMENT SYSTEMS MENTIONED IN THE GAO REPORT ARE CONTAINED IN APPENDIX III OF THAT REPORT.

IN THE BALANCE OF THE INVITATION LETTER, YOU ASKED SEVERAL QUESTIONS RELATING TO PROJECTED PERFORMANCE OF THE RETIREMENT AND DISABILITY FUND UNDER SCENARIOS THAT ENVISION INVESTMENT OF ALL OR A PORTION OF ITS ASSETS IN PRIVATE

SECURITIES.

AS YOU KNOW, ADMINISTRATION OF THE CIVIL SERVICE AND FEDERAL EMPLOYEES' RETIREMENT SYSTEMS, AND THE RETIREMENT AND DISABILITY FUND'S ASSETS, ARE ALL GOVERNED BY STATUTE. AS SUCH, THEY REFLECT A BROAD CONSENSUS BASED UPON POLICY CONCLUSIONS THAT HAVE BEEN RATIFIED BY CONGRESS AND THE ADMINISTRATION OVER MANY DECADES. INDEED, THE CREATION OF THE FEDERAL EMPLOYEES' RETIREMENT SYSTEM AND THE THRIFT SAVINGS PLAN REFLECT THE EVOLUTION OF THAT CONSENSUS. THE FEDERAL EMPLOYEES' RETIREMENT SYSTEM EXPLICITLY RECOGNIZES THAT PRIVATE SAVINGS CAN PLAY AN IMPORTANT AND BENEFICIAL ROLE IN ACHIEVING INCOME SECURITY IN RETIREMENT. THAT SYSTEM CRAFTS A BALANCE BETWEEN THE SECURITY OF A DEFINED BENEFIT AND THE RISKS ASSOCIATED WITH PRIVATE INVESTMENT.

THE BOTTOM LINE IS THAT INVESTMENT OF RETIREMENT FUND ASSETS IS AN IMPORTANT AND COMPLEX MATTER. WE SHOULD BE WILLING TO REGULARLY REVIEW THOSE POLICIES, BUT ANY CHANGES SHOULD BE MADE ONLY AFTER THE MOST CAREFUL AND CIRCUMSPECT REVIEW,

TAKING INTO CONSIDERATION THE VIEWS OF ALL INTERESTED PARTIES. MOREOVER, WE MUST BE FULLY MINDFUL OF THE POTENTIAL FOR PROFOUND BUDGETARY AND ECONOMIC CONSEQUENCES FROM SUCH CHANGES.

AS JUST AN EXAMPLE OF THAT, I WOULD CALL THE SUBCOMMITTEE'S ATTENTION TO THE TESTIMONY OF MR. JAMES BLUM, REFERENCED IN YOUR LETTER OF INVITATION. HIS TESTIMONY IN APRIL 1997 GENERALLY CONCERNED THE MATTER OF THE FEDERAL GOVERNMENT'S ASSUMPTION OF CERTAIN RETIREMENT LIABILITIES OF THE GOVERNMENT OF THE DISTRICT OF COLUMBIA. NONETHELESS, IN A BROAD REVIEW OF THE POLICY ISSUES ASSOCIATED WITH THAT TRANSFER, HE POINTED OUT THE CONSEQUENCES, BOTH NEGATIVE AND POSITIVE, OF VARYING APPROACHES TO FUNDING GOVERNMENTAL RETIREMENT BENEFITS.

MR. CHAIRMAN, THAT CONCLUDES MY OPENING STATEMENT. I WOULD BE HAPPY TO ANSWER ANY QUESTIONS YOU OR OTHER MEMBERS OF THE SUBCOMMITTEE MAY HAVE.

Mr. SCARBOROUGH. Thank you, Mr. Flynn.

I would like to start with some questions for Mr. Kelley, and I would like to just briefly compare the two systems that we are talking about today.

As I read your attachment B to the Federal Reserve testimony, it appears that the Federal Reserve Bank Plan has a higher salary replacement and retirement than FERS, and that it costs the agency less. The numbers are pretty interesting. Of the two retirement systems that have comparable benefits, the Federal Reserve system appears to cost zero dollars to taxpayers—I think I went back to 1985 or 1986—whereas the Civil Service Retirement System right now does not have money in it. We are about half a trillion dollars in debt as far as liabilities go, and it costs the taxpayers and the Federal employees, I guess, if you add them together, an aggregate of about 11 or 12 percent. And that fluctuates, obviously, year to year.

I would like to ask you, what provides the Federal Reserve System such an advantage in developing a retirement plan?

Mr. KELLEY. Well, the Federal Reserve System Plan was established in 1934, I believe, and it, from its earliest times, was able to invest more broadly than the Federal Government has invested its trust funds, and for many years it has had an equity component in it.

As you know, since World War II the basic course of the equity market has been up, and that has obviously helped the funding position of the plan. Most particularly, since 1982, when the long bull market that we are presently in had its origins, the plan has done very well.

Another point that I would make is that early on, right up until it became clear that we were substantially overfunded in this, when contribution ceased in 1986, the system itself had made very conservative—and by that I mean quite generous and substantial—contributions to the corpus of the fund. As a consequence, the funding was strong all along as a result of those contributions. Then that, of course, meant that there were funds in the plan to be able to take advantage of good markets when they came along.

Mr. SCARBOROUGH. Are the taxpayers exposed to any liability for these Federal Reserve System benefits?

Mr. KELLEY. No, sir. We have built this plan so that the only way that taxpayers could in any way be adversely affected would be that if we had such an extended period of adverse investment results that our overfunding disappeared and we somehow got into an underfunded position, and had to make bookkeeping entries that recorded a debit against our income, which would result in us having to reduce the payments we made to the Treasury.

Currently, this fund is better than just neutral for taxpayers. We are actually booking a credit against Federal Reserve income, in accordance with GAAP, as a result of this overfunded status of our plans, and that credit which we book into Federal Reserve income is remitted to the Treasury General Fund as a part of the income stream that we pay into the Treasury every week.

So actually, the taxpayer is receiving a net benefit from this fund in that sense at this time.

Mr. SCARBOROUGH. What is that credit currently?

Mr. KELLEY. I am not sure what the amount is. I believe it is on the order of $30 million or $40 million currently. It is a very complex calculation that is done in accordance with GAAP. Please do not ask me to recite to you how that accounting flows, but we would be glad to provide that to you if you would like to have it.

Mr. SCARBOROUGH. I could ask you that question, but I would not understand the answer. [Laughter.]

I went to the University of Alabama and I was very bad at math.

Let me ask you this, though. I want to followup, because over the past 2 years this subcommittee has monitored the transition of assets managed by the District of Columbia Retirement Board to the Department of the Treasury. Like the Federal Reserve, the D.C. Retirement Board had equity assets, but these were funded at only about 45 percent of the retirement benefits.

You know, in last year's omnibus appropriations bill the Secretary of the Treasury was directed to liquidate those assets, "consistent with other Federal retirement programs," and to use $2.4 billion of that to pay for other spending. Now, the employees' pensions will be paid for by Federal taxpayers rather than out of the earnings of those investments.

Let me ask you, if you will walk with me down this path, for a scenario for the Fed. Let's say we don't fix our Social Security problem, for instance, this year or any year, and at some point the economy drops into a recession and our surpluses disappear. Since we have not terminated any significant Government programs or reduced entitlement spending, we will reach 2013 with few resources and mounting Social Security deficits. The Secretary of the Treasury, who is short of funds, looks at the overfunded Federal Reserve Retirement Program and says, "Hey, I have a deal for you. I will take the extra $20 billion in your retirement fund and assure you that your annuities will be paid from the full faith and credit of the American taxpayers."

Mr. Kelley, how would you respond to the Secretary? That is question No. 1.

Question No. 2 is, are there any firewalls that have been set up in this system to make sure that your surpluses are not raided?

Mr. KELLEY. Well, I think that the answer to the Secretary of the Treasury would be in terms of those firewalls. First of all, quite aside from the political implications of such a request, those funds that we are discussing that are in the Federal Reserve Retirement Plan do not reside with or under the power of the Board anymore. Once they go into that plan, they are exclusively and legally dedicated to funding the benefits that the Board has contracted for with its employees, and in that sense they belong to the beneficiaries. We have some good lawyers here in the room, and I am not a lawyer at all, but I do not believe it would be possible for us to touch that fund for that purpose if we should somehow desire to do so.

Mr. SCARBOROUGH. OK. So your funds cannot be raided in the same way the D.C. funds were, then?

Mr. KELLEY. No, sir.

Mr. SCARBOROUGH. OK.

Let me ask you a question about whether there is any sort of rub here between your system and other systems. It has to do with the

investing that you have talked about already in this committee. I have a couple questions for you. Alan Greenspan, in January, testified before the Ways and Means Committee, and they were talking about private investment of Social Security funds. Obviously, as you know, Chairman Greenspan opposed that, in part because there was the potential for politics getting involved in investment decisions.

Nonetheless the Fed itself, in its own system, will invest with some guidelines; and the provision says, as you know, "no investment should be made or continued in a company whose products or activities are subject to broad-based social or political censure." That vision is contained in a July 22, 1998 memo approved by the Committee on Investment Performance, and it certainly sounds like a preemptive strike against social investment.

What was the first time it was introduced? When did such a provision first enter the Fed's guidelines?

Mr. KELLEY. My best recollection of that—and frankly, I am not very clear on the history of that provision—but I believe that it did come to the attention of the Investment Committee perhaps no further back than 1996 or 1997, and was considered for a period of time and eventually passed by the Investment Committee and became one of our guidelines.

Mr. SCARBOROUGH. OK. And let me ask you this, because we are obviously comparing two systems, your system which is extremely successful—and one of the questions that we are going to have to ask not only about the future of other retirement systems, but also of Social Security, is how we walk this fine line, if you could provide me some guidance.

Again, I want to key back on the words that are part of your guidelines which say that you are going to stay away from activities that are subject to broad-based social or political censure.

Could you help put a little bit of meat on those bones? Would that include tobacco companies, gun companies, pharmaceutical companies that produce certain products that are objectionable? Help me out here.

Mr. KELLEY. Since that became one of our guidelines, it has not been further discussed in terms of any practical recommendation or suggestion that something be proscribed. So there is no flesh to put on those bones at this point.

Mr. SCARBOROUGH. OK.

Mr. KELLEY. It has not been dealt with, as a practical matter, nor has any particular security of any sort been proscribed under that guideline.

Mr. SCARBOROUGH. So there has not been an investment that your Board has wanted to move on that has been stopped because of that?

Mr. KELLEY. No, sir.

Mr. SCARBOROUGH. OK.

I wanted to ask a question or two of you, Mr. Flynn, briefly. When we read about the long-term problems facing the Social Security System, which is funded by the same pay-as-you-go mechanism, obviously, that most Federal retirement systems are funded under, citizens are alarmed because of a shortfall that could begin

in the next 10 to 15 years, when the baby-boom generation starts to retire.

Federal employees have been in such a shortfall condition for more than 20 years, and this year payroll deductions and employer contributions will provide less than one quarter of the funding needed to support current pensions. OPM's annual reports have projected that the shortfall will increase to more than $100 million annually within the next 20 years.

In the 105th Congress, the Budget Committee directed this committee to reduce the deficit in direct spending by amounts of about $4 billion. The Budget Committee proposed options that included COLA delays, changing the retirement benefit calculation base from high-3 to high-5, and increased retirement contributions from employees and their agencies.

Some tough choices have been made with respect to COLA delays and benefit cuts, but employees are paying more for their retirement benefits, and will be, at least for the next 4 years.

Mr. Flynn, does the absence of funding that is independent of current receipts leave employees and annuitants continually vulnerable to proposals to delay cost of living adjustments, to reduce benefits in some other ways, or to increase contribution levels, or do other things that may not be helpful to Federal employees and retirees?

Mr. FLYNN. Mr. Chairman, that is a big question. Let me try and perhaps set a little context, and then give you an answer.

The Civil Service Retirement and Disability Fund, the trust fund that we manage at the Office of Personnel Management, contains assets for two retirement systems: the old Civil Service Retirement System, that was essentially closed to new entrants in 1983, and the new Federal Employees Retirement System, to which almost all new Federal employees today are appointed.

You talked a minute ago about the unfunded liability of the Retirement Fund. The unfunded liability, which is, as I think you indicated, Mr. Chairman, $512 billion or $518 billion, is an unfunded liability that is exclusively the product of the way in which the Government financed the older Civil Service Retirement System. The newer Federal Employees Retirement System is designed to be financed under Government financing mechanisms, to be financed on a fully funded, accruing basis, so that the employee contributions and agency contributions that are coming in every 2 weeks will finance the benefits of the participants in that system.

So if I could, just real quickly, separate out where the unfunded liability is, and then talk about that just for a second, because it is something that oftentimes gets misunderstood and does in fact, from time to time, lead to suggestions in the context of the overall budget for reducing benefits, whether that be in the form of cost of living adjustments or different formulas for determining what a monthly annuity would be, and so on and so forth.

The unfunded liability has been recognized. It has been recognized, disclosed, and reported since 1969. A series of amendments occurred in 1969 to limit the continued growth of the unfunded liability, and a series of legislative initiatives from 1969 until the creation of the Federal Employees Retirement System did the same thing.

The Federal Employees Retirement System has a mechanism in it that ultimately will finance the unfunded liability of the Civil Service Retirement System. So there was, in 1983, specific legislative action agreed to by the Congress and ratified by the administration that deals with that unfunded liability over time.

The second point that I want to make is that if you look at the Retirement and Disability Fund as consisting of two programs, the assets of the fund—that is to say, the assets of the older system and the newer system—are available to pay all the benefits required of the system. So even though, on an ongoing basis, receipts to the fund do not match outlays from the fund on a year-to-year basis, the fact of the matter is that the balance of the fund is available to pay benefits, and there will always be a balance available to pay benefits for as long as anyone cares to project into the future.

Now, when it comes to the Federal budget at large—not just the retirement system—the manner in which Federal programs are financed does make these retirement programs, and other programs, subject to scrutiny from 1 year to the next. That is part of the process and that is something that we have all had to deal with. There have been hearings here and in other forums about protecting the Government's retirement fund from those kinds of situations, and there are views, obviously, on both sides of the question. But just to set that as a context, I hope that helps a little bit.

Mr. SCARBOROUGH. It does. And I have a few more questions, but I would like to pass it over to the ranking member, Mr. Cummings.

Mr. CUMMINGS. Thank you, Mr. Chairman.

I am trying to figure out, Mr. Kelley, the timing of this legislation here. Can you kind of just give us a little more background as to why we are acting now? And was there something in particular that made this happening right now very important? I understand what the problem is; I am just trying to figure out——

Mr. KELLEY. No, you do indeed. Your summary was excellent. But there are two things that I would mention there.

No. 1 is that if anyone who is caught in this situation at this time, whereby they have this split pension calculation under current law, if they were to retire now or before this legislation is passed, their retirement would be figured on the current law basis and they would be stuck. To my best knowledge that has not happened to anyone yet, but it could at any time, because of course, folks get a year older every year. It will happen if the law does not pass.

We have been aware of this for some time, and I believe this legislation has been around for 5 years now, and another phenomenon is happening. I believe you were the one who summarized a number of employees at the Board who are in this dilemma at this time, in that they are covered by what we call the Bank Plan due to their post-1984 employment. The ones who have full reciprocity under present law are our older employees, who are covered by our Board Plan, which is fully fundable back-and-forth with the CSRS. But the phenomenon that I would point out to you is that these are older employees who currently enjoy adequate portability, and they are going to decline in number over time. And meanwhile, the ones who have come to the service post-1984 are slowly going to become

all of our employees; and over the course of a very few years, if this were to languish, our entire workforce would be in this unidirectional problem.

So I believe there is considerable urgency in those two senses to get this done.

Mr. CUMMINGS. Now, with regard to your hiring new people, do you believe or have evidence that this has been a factor in whether people come on with you?

Mr. KELLEY. I am told that it is, because people like to have the thought that they can transfer to other agencies and perhaps come back to the Board, and perhaps come to the Board briefly and then go back to their home agencies. So as you or perhaps the chairman observed, there is not a huge number of these individuals—I guess it was Ms. Norton—but even though they are not many, they are very important Government servants who are providing important service to our country, and I do not believe that they ought to be inhibited or disadvantaged in their ability to provide that service at the highest and best location that they are called to. But there is, under this present law, a very meaningful inhibition on the part of folks who are in this situation to move about and perhaps pursue their career objectives at the highest and best level.

Mr. CUMMINGS. Now, this is modeled after the Foreign Service law, is that right? It was an effort to correct the Foreign Service situation, is that correct?

Mr. KELLEY. I do not think anyone is clear as to how this happened, and our folks have tried to find some reference in the legislative history here. But somehow, when the new plan got set up in 1983, there was a provision made for the Foreign Service, which is exactly what we need—but only for the Foreign Service.

Mr. CUMMINGS. Mr. Flynn, do you know of any other agencies that this would apply to? This is it? In other words, agencies in a similar situation?

Mr. FLYNN. There are a number of other Federal retirement systems, Mr. Cummings, where this potentially could apply, but generally speaking they are small, specialized retirement plans for Federal judges, members of the Farm Credit System, things of that nature.

I think that with the Foreign Service Retirement System and the Federal Reserve Board, we are probably looking at the two retirement systems where this would be most likely to occur. We would not expect to see it in others, but we certainly would be willing to look at the interest of others if that should materialize.

Mr. CUMMINGS. So nobody has presented a case to you?

Mr. FLYNN. No.

Mr. CUMMINGS. I am just wondering, we have a situation where we are trying to correct a problem. I think you said, Mr. Kelley, that it has been around for a while.

Mr. KELLEY. Yes, sir.

Mr. CUMMINGS. Since I am fairly new to the Congress, I am just curious. Has there been an objection to it? Or is just language in the legislative process? What has been the issue, do you know?

Mr. KELLEY. Well, I personally am new to this issue, also. It has fairly recently come to my attention. But I am told that we have been aware of it for some time, and it has been presented to the

Congress before, but before H.R. 807 it has always been mixed up in other legislation and for one reason or another fell by the wayside in the process and just never got done.

Mr. CUMMINGS. Mr. Flynn.

Mr. FLYNN. Mr. Cummings, I would agree with Governor Kelley. This is a matter that we have known about. The numbers are small. There have been provisions under consideration in the past, and I think it has gotten ripe at this point. But I am not aware of any objections in the past.

Mr. CUMMINGS. OK. I thought maybe there was something that we were missing. When you get this kind of bipartisan spirit, you begin to wonder whether we are missing something. [Laughter.]

Mr. Flynn, you noted that the GAO report is 3 years old?

Mr. FLYNN. Yes, sir, 1996.

Mr. CUMMINGS. Yes. Is that significant? I mean, should it be updated?

Mr. FLYNN. I do not think it is particularly significant. It is a broad overview of the Federal retirement systems that are available. The appendix to the report, obviously, is going to contain financial information that is that old or older, because it takes time to collect it. And with the exception of reflecting, for example, the performance of the equity markets over those past 3 years, I do not think that substantively there would be any particular reason to suggest that it is out of date and needs to be updated.

Mr. CUMMINGS. So I take it that if we do not act on this soon, this year or next year, it just creates more problems for more people?

Mr. FLYNN. Yes, sir.

Mr. CUMMINGS. All right. Thank you very much.

Mr. SCARBOROUGH. Thank you, Mr. Cummings.

Just a couple of quick followups. First of all, if I am not mistaken, in the 104th Congress we did pass this reform out of this subcommittee and committee and the House. It was attached to another bill, which was killed in the Senate. Imagine that.

Second, just a quick followup, Mr. Flynn. I was curious, what about the intelligence retirement system? Do they have portability, that you know of?

Mr. FLYNN. They have portability. As I mentioned, in terms of the older systems, I think I would have to check on post-1988 portability prospectively and perhaps give you an answer to that.

Mr. SCARBOROUGH. If you could provide us with an answer to that, we can make that part of the record, without objection.

Mr. FLYNN. I'd be happy to.

[The information referred to follows:]

Existing law deals with the issue of credit for post-1988 service of Central Intelligence Agency employees. CIA employees first hired prior to 1984 are covered under either the Civil Service Retirement System (CSRS) or the Central Intelligence Agency Retirement and Disability System (CIARDS), depending upon the nature of their duties. Because such individuals would be eligible for CSRS coverage if they leave CIA service to enter other Government service, service credit for post-1988 CIA service would be available. If an individual previously covered by CIARDS were to elect FERS coverage upon entering non-CIA employment, the post-1988 CIARDS service would be available for credit as part of a CSRS component of the FERS annuity.

When FERS was established, the law was drafted to provide that all post-1983 CIA retirement eligible employees would be covered by FERS, including those individuals who perform duties of the type that would have resulted in CIARDS coverage under prior law. While there are special FERS provisions (*see*, 50 U.S.C. §§2151, *et seq.*) for individuals performing the types of duties performed by CIARDS covered employees, there is not a separate CIA retirement system parallel to FERS.

Mr. SCARBOROUGH. I would like to introduce and recognize the gentlelady from Maryland, Mrs. Morella.

Mrs. MORELLA. Thank you, Mr. Chairman. I want to congratulate you and to congratulate us on the Civil Service Subcommittee on having you chair it. I look forward to working with you during this Congress.

I am chairing another committee right now, but I wanted to come down for the markup on these two bills and the opportunity, having looked at your testimony, to perhaps pose one question that pertains to the second bill that we are going to mark up, which has to do with our Thrift Savings Plan enhancements, which deals with portability and deals with allowing people to join our Thrift Savings immediately.

But picking up on the Federal Reserve, Mr. Kelley and Mr. Flynn, let us look at Thrift Savings. FERS employees contribute to their Thrift Savings Plan accounts, and you have mentioned that Federal Reserve employees can contribute up to 20 percent of pay to either pre-tax or post-tax investment options, up to the IRS cap?

Mr. FLYNN. Yes, ma'am.

Mrs. MORELLA. FERS employees are capped at 10 percent contributions to their pre-tax TSP accounts, even if these limits leave them well below the IRS caps.

For the past 4 years this subcommittee has been unable to advance a proposal—we have advanced it out of the subcommittee, out of the full committee, on the floor of the House—this proposal, allowing the employees to contribute to the IRS limit. The administration opposes the provision for budgetary reasons.

I want to ask both of you, how does the Federal Reserve do for its employees something that we cannot enact for other Federal employees?

Mr. KELLEY. I would not want to try to answer that, but I would like to say that I think our employees consider their ability to contribute up to the maximum permissible limit under IRS regulations to be a very valuable benefit. While I do not have any statistics at my fingertips as to who does that, my impression is that a very substantial percentage of Federal Reserve employees are contributing up to the maximum. In fact, I think that our H.R. people have a considerable burden of helping people to figure out just how much they can in fact contribute without getting into trouble, because it is considered to be a very important opportunity.

Mrs. MORELLA. Mr. Flynn, do you not see an inequity in this, sir?

Mr. FLYNN. Mrs. Morella, I will try to be as artful as I can in my answer.

I seem to remember a similar question that you asked Director LaChance at a hearing very similar to this, not very long ago——

Mrs. MORELLA. Yes.

Mr. FLYNN [continuing]. Where she offered, I think, her view that there is ample evidence about the small savings rate that we see in the economy, and she pointed out how important it is to the President that there be savings for income security and retirement. In fact, there was a summit convened on that very topic last June. And in looking at those two factors, she indicated that she thought that anything that could be done that would encourage people to

save for income security and retirement was a good thing, and I think that is a view that I would share as well.

Mrs. MORELLA. I appreciate that very much, and I think the President and the Treasury Department are going to realize that these savings that he believes in, that we all believe in, since the United States has such a low savings rate, is one that certainly should be allowed for individuals to enhance their savings and their pension retirement funds by virtue of an equity. Mike Causey has written about it a great deal. I know of nobody who disagrees on both sides of the aisle, even with different philosophies of it. As a matter of fact, the President has this—what is it, the new "USA 401(k)" and yet our Federal employees cannot even give that amount.

So I guess I am hearing from both of you that you do think it is a good idea and will continue to push that forward with the help of this subcommittee and the full committee and the Ways and Means Committee.

I thank you.

Thank you, Mr. Chairman, for allowing me to get that little lecture in.

Mr. SCARBOROUGH. OK, thank you so much.

We are going to go ahead and finish up the hearing and then go to the markup after the vote, so the Chair now recognizes the gentlelady from the District of Columbia, Ms. Norton.

Ms. NORTON. Thank you, Mr. Chairman.

Mr. Kelley, I regret that my opening statement may have been unclear. I didn't realize, and should have, that the Board would have its own version of a Thrift Savings Plan. I should have realized that if the Federal Government had that, then certainly the Board of Governors would have had that for its own employees.

I would like to know whether, under our bill, when an employee transfers, will the entire corpus—what the Government has contributed and what the employee has contributed—simply transfer over, so that perhaps no contribution will have to be made in order to come into our own Federal Government agency's Thrift Savings Plan?

Mr. KELLEY. Well, we have to be careful. We are talking about two different plans now. Basically, the portability that we have been discussing in H.R. 807 has to do with the defined benefit plan, the pension plan itself, and there are rather complex arrangements that have to be made technically to make sure that there is equity between plans when an employee goes from one plan to another. But that can be done, and it is fully taken care of in your bill.

The other plans are defined contribution plans. The Thrift Savings Plan and our Thrift Plan are defined contribution plans, and there still is a problem of portability when one goes from a Thrift Savings Plan institution to us. Portability there is not perfected and is not at this time in your bill.

Ms. NORTON. So if the employee was in your Thrift Savings Plan, what happens to the contributions that the employee has made in your Thrift Savings Plan if the employee wants to now join the Thrift Savings Plan of a Federal agency?

Mr. KELLEY. Well, first of all, it is fully vested and is entirely theirs, so there is no way they are going to forfeit anything out of that plan.

Ms. NORTON. All right. So it really is two different plans?

Mr. KELLEY. That's right. And they have two different sets of effects.

Ms. NORTON. I see. But they can go into our Thrift Savings Plan——

Mr. KELLEY. Yes. Now, I am frankly not clear about the portability out of our Thrift Plan into the Thrift Savings Plan. I would be very happy to generate an answer to that question and provide it to the committee if that would be helpful.

Ms. NORTON. Mr. Chairman, I would appreciate this information very much, because I am not sure what happens to the Government's contribution. Then there is the contribution that the employee has made, and now you have two Thrift Savings Plans, and I am not sure what the bottom line effect is, and I think that for employees for whom these plans are so valuable, that would have meaning.

So I would appreciate receiving an answer. I don't have any problem with marking up the bill, but I would appreciate an answer.

Mr. KELLEY. We would be very happy to do that.

Mr. SCARBOROUGH. If you could forward that and we will make it a part of the record, if there is no objection.

[The information referred to follows:]

Governor Kelley subsequently submitted the following information.

When an employee separates from the Federal Reserve, he/she has the right to leave his/her funds on deposit in the FR Thrift Plan. Although the separated Plan member may no longer contribute to the Thrift Plan account, he/she may make withdrawals, take loans, or transfer funds between investment options. Or, if the member chooses, he/she may withdraw the entire account and may "roll over" the taxable funds to an IRA or other qualified plan.

The Federal Reserve Thrift Plan member is prevented from rolling over taxable funds to the Federal Thrift Savings Plan (TSP) because TSP does not permit incoming rollovers from any source. Therefore, a Thrift Plan member at the Board who transfers to another government agency must begin TSP participation as a new hire and is not able to consolidate his/her savings from the Board with a TSP account.

Congresswoman Morella has introduced legislation that would allow TSP to accept rollover payments. If this or similar legislation is passed, the FR Thrift Plan participant and other similarly situated employees would benefit.

Ms. NORTON. Is what we are doing today retroactive, so that if somebody is retired, if 1 of these 50 folks is gone, that person can be made whole? Or is that person just a loser?

Mr. KELLEY. My understanding is at this point, if this bill is passed promptly, there will be no losers. But we run that risk if this runs on and on.

Ms. NORTON. All right. I want to make sure of that. I have in mind the employee who says, "Well, I have to go; this is such a better opportunity at XYZ Agency," she goes, is lost, and may have retired from XYZ Agency. Now I just want to make sure that we do not end up with yet another bill needed for yet another set of losers.

Mr. KELLEY. Over my right shoulder, I am assured that you are correct on that.

Ms. NORTON. OK.

The chairman has raised a very important point about what happened to the D.C. Retirement Fund. First I want to make it abundantly clear that it is the Congress that forced the District to turn over its funds and to spend out of its funds. That's the last thing that the District would have wanted to do. But what the Congress said was that this pension liability, which is 100 percent Federal liability, "we will not take on. What we will do, and the only way we will take this on, is if you pay down—you, District of Columbia employees—what you have put into it. At that point we reduce our costs, and we are willing to take over what we should have had in the first place." So that was the first inequity.

But the District of Columbia had absolutely no choice because if this fund were still outstanding in 2004, the District would go bust, if I can use a colloquial expression. That is to say, it would not be what we have just gone through, which is the kind of insolvency that Philadelphia and New York had. The city would blow up because a huge amount would fall due; the Federal Government pulls back and is not a part of the fund at all. So the District, in essence, was forced to liquidate what employees had already paid in.

Second, the Federal Government should not have wiped out the fund, and I certainly agree with the chairman that that is the last thing we envisioned would happen. But someone told me after this happened that, "Eleanor, didn't you recognize that the Federal Government never leaves any loose change hanging around?" [Laughter.]

What in effect has happened is that the obligations have now been consolidated, in effect, into the Federal retirement obligations, and under law there is no way to avoid that now unless the Federal Government were to pass additional legislation saying we no longer are obligated.

I do want to say that I would have preferred to see the fund left intact, and for it to build on the equity already in the fund. It would have saved the Government money. We already had a system that was doing well. So I regret it, but I do think that we ought to understand why it happened that way. Because of the way scoring is done, the Federal Government—the administration—said no, the Congress certainly was not willing to come up with the money, and so essentially we were left with a take-it-or-leave-it

proposition. We had to take it because we could not afford to be left there a few years from now, essentially with a city in smoke.

I would like to ask a question—I know I am holding people up, but I want to ask a question about investments, though, because I do think that the question that the chairman has put on the table about investment in equities is one that has to be considered, especially since the President wants to invest Social Security funds. Those of you who have a vote may want to run over and vote and not have to be making a 50-year dash, so I will leave it to the chairman, because I think your time is running.

Mr. SCARBOROUGH. Well, it is running. If you were to submit the written questions, we could leave the record open for 2 weeks and they could answer them.

Ms. NORTON. I would be pleased to do that.

[Questions and answers referred to follow:]

RESPONSES TO CHAIRMAN SCARBOROUGH'S LETTER TO GOVERNOR KELLEY

Q: Please describe the legal provisions which make any "surplus" under the Retirement Plan for Employees of the Federal Reserve System unavailable for use as governmental revenues.

Background

The Retirement Plan for Employees of the Federal Reserve System ("Retirement Plan") is a tax-qualified pension covering employee-participants both of the Board of Governors of the Federal Reserve System ("Board") and the twelve Federal Reserve Banks. The Retirement Plan consists of two component benefit structures applicable in two distinct participant groups. The "Bank Benefit Structure" applies to all Reserve Bank employees, and to those Board employees hired on and after January 1, 1984. The "Board Benefit Structure" applies only to those Board participants hired prior to January 1, 1984. All employer and employee contributions made under the Retirement Plan are held under a single trust, are commingled and invested, and are available to pay benefits to any participant or beneficiary under the Retirement Plan.

Qualified Plan

The Retirement Plan and its related trust agreement are designed to meet all of the qualification requirements contained in Section 401(a) of the Internal Revenue Code of 1986 ("Code"). Because the Retirement Plan is a "qualified" plan, the participants are entitled to the federal income tax protections which flow from this status. Consequently, participants and their beneficiaries under the Retirement Plan are subject to income tax only upon actual receipt of a Plan distribution. Currently, the value of plan assets held in trust under the Retirement Plan

exceeds the aggregate amount of accrued Plan benefit liabilities as determined by the Plan's independent actuary. As detailed below, the qualification requirements under the Code prevent the use of the "excess" or "surplus" for any purpose, including as government revenues, except for the benefit of employees.

Specifically, Section 401(a)(1) of the Code requires that all plan assets, including employer and employee contributions, be held in trust. Section 401(a)(2) of the Code further provides that such trust must make it impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, for any of the trust assets (both corpus or income) to be used for, or diverted to, purposes other than for the exclusive benefit of such employees or their beneficiaries. Income Tax Reg. Section 1.401-2(a)(2) provides, in part, that the trust instrument must definitely and affirmatively make it impossible for the nonexempt diversion or use to occur, whether by the happening of a contingency or by any other means. The trust agreement under the Retirement Plan contains a specific provision complying with this requirement. Moreover, Revenue Rulings 60-276, 77-200 and 91-4 affirm the applicability of the exclusive benefit rule to all trust assets while permitting the return of employer contributions and earnings attributable thereto in very limited circumstances not here relevant. In sum, the Retirement Plan and its related trust have been drafted and consistently operated in accordance with this Code requirement in order to secure and preserve the tax-qualified status of this Plan for the benefit of all of its participants.

Q: Please provide additional information regarding administration of the social investment clause applicable to the Retirement Plan.

As you know, the Federal Reserve System's Committee on Investment Performance seeks to avoid investments in companies that are subject to "broad-based social or political censure" (under its *Investment Guideline No. 7)*. Since the Committee delegates security selection to its investment managers, except for a prohibition on purchase of certain financial stocks, those managers are expected to assess the appropriateness of each potential investment in light of the policy set forth in *Guideline No. 7*. The managers are aware of this expectation because the Committee's *Investment Objectives and Guidelines* document appears as a rider to each investment advisory agreement. Staff of the Federal Reserve's Office of Employee Benefits also ask each manager to certify compliance with the *Guidelines* in writing at least annually. Finally, staff reviews all portfolio holdings monthly and discusses potential *Guidelines* violations with the manager. If any matter is not resolved to the staff's satisfaction, it is immediately brought to the Committee's attention. No issues have been referred to the Committee for action under *Guideline No. 7* since at least 1982.

There have been no changes in the Committee's policy or practice with regard to *Guideline No. 7* since its adoption in 1978. Staff has, on occasion, been approached by managers wishing to informally discuss the appropriateness of certain holdings. In such instances, staff will disclose whether any such investment has been made in another Plan account and whether the Committee is currently considering action in that regard. Staff will usually counsel the manager to have a longer term perspective in assessing the products and services of the company

at issue. While this counseling has sensitized managers to potential issues, it has always been presented in the broader context of the need to maximize the Plan's long term portfolio return.

Staff reports to the Committee from time to time on the relative performance of investment funds having "social investing" screens. These reports might include a comparison of the College Retirement Equity Fund's Social Choice Account with its own Stock Fund, or an assessment of the performance of the 49 mutual funds currently in the Morningstar, Inc. Mutual fund universe having social objectives. Longer-term analyses of these and similar data suggest that portfolios unencumbered by social screens tend to generate higher returns, although the scholarship is by no means decided on this point. Staff has not, however, been able to assess the impact of *Guideline No. 7* on the Plan's performance because we have no knowledge of what managers may have held without our *Guideline* limitation.

Retirement Plan for Employees of the Federal Reserve System

(Response to Item "C" in Chairman Scarborough's letter dated February 8, 1999)

INVESTMENT PERFORMANCE

Year	Total Return [1]	60/40 Composite Benchmark [2]
1989	24.86 %	24.30 %
1990	2.45	1.72
1991	30.77	24.79
1992	7.36	7.66
1993	7.70	9.99
1994	0.91	-0.35
1995	30.08	29.62
1996	18.13	14.96
1997	22.39	23.62
1998	18.98	21.08
Compound Annual Return for the Past 3 Years	19.83 %	19.83 %
Compound Annual Return for the Past 5 Years	17.70	17.32
Compound Annual Return for the Past 10 Years	15.88	15.30

[1] Before investment management fees, but net of spreads and commissions.

[2] Represents 60% S&P 500 / 40% Lehman Bros. Aggregate Index.
(40% Lehman Bros. Government / Corporate before 1993)

Office of Employee Benefits
February 11, 1999

RESPONDS TO (A) AND (B) ON

PAGE 2 OF

SCARBOROUGH LETTER

PERCENT OF PAYROLL CONTRIBUTED TO THE RETIREMENT FUND BY EMPLOYERS AND EMPLOYEES *

YEAR	EMPLOYER CONTRIBUTIONS	EMPLOYEE CONTRIBUTIONS	SALARY LIABILITY	EMPLOYEE PERCENT	EMPLOYER PERCENT
1988	$ 0	$ 2,342,635	$ 699,875,779	0.33%	0.00%
1989	0	2,451,339	746,183,024	0.33%	0.00%
1990	0	2,619,746	799,981,485	0.33%	0.00%
1991	0	2,799,359	853,489,160	0.33%	0.00%
1992	0	2,744,408	918,471,310	0.30%	0.00%
1993	0	2,819,822	957,800,795	0.29%	0.00%
1994	0	2,825,865	974,049,428	0.29%	0.00%
1995	0	10,551,955 **	1,022,274,344	1.03%	0.00%
1996	0	3,583,634	1,056,157,004	0.34%	0.00%
1997	0	3,636,045	1,077,044,360	0.34%	0.00%
TOTAL	0	36,374,808	9,105,326,689	0.40%	0.00%

* Only employees enrolled in the Board Benefit Structure contribute to the Retirement Plan. They are required to contribute 7% of salary. Employees covered under the Bank Plan are covered under Social Security and, as such, incur FICA tax withholding.

** Includes deposits in the amount of $7,597,048 made by 138 members who transferred their service from CSRS to the Board Benefit Structure. The only contributions made on behalf of these members were employee contributions.

RESPONDS TO REQUEST ON PAGE 1, 3RD PARAGRAPH OF SCARBOROUGH LETTER

BENEFIT LEVELS AND COSTS OF THE FEDERAL RESERVE RETIREMENT PLAN

REPLACEMENT RATIOS

ENTRY AGE	YEARS OF SERVICE AT AGE 65	BANK PLAN REPLACEMENT RATIOS * RATE OF PAY ($44,000)	($62,000)	($160,000)	BOARD PLAN REPLACEMENT RATIOS **
25	40	58%	62%	68%	76%
30	35	51%	54%	60%	66%
35	30	44%	47%	51%	56%
40	25	36%	39%	43%	46%
45	20	29%	31%	34%	36%
50	15	22%	23%	26%	26%

* It should be noted that replacement ratios do not include income from Social Security. Board Benefit Structure members do not earn Social Security credit while covered under the Board Benefit Structure.

** Unlike the Board Benefit Structure that applies the same benefit formula to final average pay, the Bank Plan benefit formula provides a larger benefit to those with high final average salary because less of their income will be replaced by Social Security.

COST OF PLAN

	PERCENT OF ANNUAL PAY		
	EMPLOYEE	EMPLOYER	TOTAL
BANK PLAN ***	0.00%	6.75%	6.75%
BOARD PLAN	7.00%	9.50%	16.50%

*** Excludes employees of the Board of Governors covered under the Bank Plan

RESPONDS TO (C) ON

PAGE 2 OF

SCARBOROUGH LETTER

Approved by the Committee on
Investment Performance

July 22, 1998

INVESTMENT OBJECTIVES AND GUIDELINES FOR THE MANAGEMENT OF ASSETS OF THE RETIREMENT PLAN FOR EMPLOYEES OF THE FEDERAL RESERVE SYSTEM

INTRODUCTION

The basic purposes of the Retirement Plan for Employees of the Federal Reserve System were developed between 1919 and 1934, when plans for establishment of a retirement system for Federal Reserve System employees were proposed, reviewed, and refined. The original plan for a Federal Reserve retirement system involved creation of a separate corporation by an act of Congress to assure separation of the finances of the pension fund from those of the Reserve Banks and the Board of Governors.[1] While the Retirement system of the Federal Reserve Banks, established in 1934, had many of the features of the earlier proposals, particularly the separation of Retirement System finances from those of the Reserve Banks and the Board, the organization took an unincorporated form with responsibility for general administration vested in a Board of Trustees.[2] At the present time, responsibility for the general administration of the Retirement Plan is vested in the Committee on Employee Benefits composed of three members of the Board of Governors of the Federal Reserve System and two Presidents of the Federal Reserve Banks.
Plan investments are supervised by the Committee on Investment Performance.

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1 Legislation to establish such a pension system, sponsored by the Federal Reserve System, was introduced in Congress in March 1926. That bill passed the Senate but failed to pass the House of Representatives. Similar legislation was introduced in Congress from time to time thereafter but never passed both Houses of Congress.

2 The name of the Retirement System was changed in 1970 to Retirement Plan for Employees of the Federal Reserve System.

GENERAL PURPOSES OF RETIREMENT PLAN

The Retirement Plan was designed and has been administered to assure fulfillment of the following general purposes:

1. To attract and retain quality personnel by providing a system for orderly retirement of employees from active service in the event of old age or disability.

2. To promote the confidence of the staff in the Retirement Plan by providing for its independence from the operations of both the Federal Reserve Banks and the Board of Governors. With an independent Retirement Plan, employees have greater assurance that the availability of benefits from the Retirement Plan will not be directly affected by the operations of the Federal Reserve System.

3. To administer the Retirement Plan on an actuarial reserve basis so that funds sufficient to pay a pension at the time of each employee's retirement are provided over the entire period of employment.

4. To have a single retirement system for all Reserve Banks and the Board of Governors so that the total expense of provision of such benefits is reduced through centralized administration, the spreading of exposure to loss, and the sounder actuarial calculations possible with large numbers of employees.

Given these basic purposes, this paper sets forth (1) the investment objectives, (2) the investment guidelines, and (3) the performance review processes that have been adopted by the Committee on Investment Performance for the investment managers of the funds of the Retirement Plan.[3] In adopting the objectives consideration was given, among other things, to the investment of the Retirement Plan in fixed income contracts.

The investment objectives apply to all assets, except fixed income contracts, held under investment for the Retirement Plan. The investment guidelines are applicable to assets committed to investment under an individual separate account of an insurance company, and assets committed to investment under the direction of an investment adviser. It is also expected that assets committed to investment under any commingled separate account will be managed in a manner broadly consistent with the guidelines.

INVESTMENT OBJECTIVES

The broad investment objective of the Retirement Plan is continuity in total rate of return at a level consistent with prudent management concerned with safety of principal. Investments should be high-grade and produce the best available total rate of return, recognizing that quality of investment is as important as yield. Attention will also be paid to the degree of volatility of return on the portfolio.

Given these broad objectives, the funds of the Retirement Plan should be invested in accordance with the following considerations:

1. The relationship within the portfolio, as between Equity and Other Investments (including, but not limited to, cash and debt securities) shall

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[3] Prior to January 1, 1979, the Committee was called the Performance Review Committee.

be maintained on a market value basis within the boundaries of (1) 40 percent Equity and 60 percent Other Investments, and (2) 80 percent Equity and 20 percent Other Investments. Investment transactions will be monitored regularly by the Committee on Investment Performance.

2. Performance will normally be measured over a full securities market cycle or a period of at least three years. Although it is expected that the portfolio would not maintain a fixed percentage relationship as between Real Estate, Equity, and Other Investments, performance will be evaluated against the return obtainable on a portfolio having investment allocations of 60 percent Equity (earning the return obtainable on the Standard & Poor's 500 Common Stock Index) and 40 percent Other Investments (earning the return obtainable on the Lehman Brothers Aggregate Bond Index).

3. Emphasis should be on consistency of performance. In this connection, volatility of the common stock portion should not normally substantially exceed the volatility of the Standard & Poor's 500 Common Stock Index.

INVESTMENT GUIDELINES

Investment managers have full discretion in the investment decisions they make to achieve the previously stated investment objectives, subject to the following guidelines:

1. Although the Retirement Plan is generally not subject to the Employee Retirement Income Security Act of 1974 ("ERISA") because it is a "governmental plan", investment decisions should be consistent with the

"prudent man" principle under ERISA,[4] as well as the objectives and guidelines set forth herein.

2. Investments should be diversified to minimize the risk of large losses, unless it is clearly prudent not do so.[5]

3. Although investments should be made with long-term objectives in mind, assets may be disposed of, without regard to the length of time they have been held, whenever investment considerations make such action advisable.

4. Investments should not be concentrated in particular industries or a grouping of related industries.

5. Holdings of equity securities of any one company should not exceed eight percent of the market value of the equity portfolio being managed.

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[4] ERISA provides that "...a fiduciary shall discharge his duties...

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;..." 29 U.S.C.A. s 1104(a) (1) (1975).

[5] ERISA also provides for this requirement with respect to the responsibilities of a fiduciary. Ibid.

6. No investment should be made for the purpose of exercising control over, or management of, the company that issued the securities.

7. No investment should be made or continued in a company whose products or activities are subject to broad-based social or political censure.

8. No money should be borrowed for the purpose of investment or otherwise. (This guideline does not preclude managers of commingled real estate investment accounts from incurring mortgage debt.)

9. Purchases should not be made on margin.

10. Short sales should not be made.

11. There should be no trading in foreign exchange, or puts or calls, or writing of options.

12. There should be no purchase of commodities or commodity contracts.

13. There should be no purchase of stock (or securities convertible into stock) in banks (including bank capital securities), bank holding companies, savings and loan associations, Government securities dealers, or enterprises engaged primarily in mining or trading in gold. This prohibition, however, does not preclude the purchase of stock in a firm whose shares could be purchased under the first sentence of this guideline, but that has one or more subsidiaries or affiliates whose shares by themselves could not be purchased under such sentence, provided that the total contribution of all such subsidiaries and affiliates to the

revenue or net income of the consolidated firm is not significant. Ordinarily, a contribution by such subsidiaries and affiliates that does not exceed 25 percent in any fiscal year should not be considered significant.

14. There should be no purchase of the securities of the portfolio manager's organization or of the holding company of the portfolio manager's organization.

15. There should be no purchase of unregistered or lettered stock. All securities should be rated investment-grade by at least one of the major credit rating services, be fully negotiable and marketable. Managers holding securities that were investment-grade when they were purchased, but were subsequently downgraded, may hold them for up to six months if market conditions for the sale of these securities are expected to improve, or for up to twelve months if upgrading is considered likely. Managers may purchase non-rated pass-through securities if the underlying securities are investment-grade or there is a sufficient degree of overcollateralization.

16. No insurance company serving as an investment manager should make any investment in any general account administered as part of the company's general asset portfolio.

17. Deleted (July 21, 1997)

18. Deleted (July 21, 1997)

19. Purchase of units of participation in commingled real estate investment accounts may be made only to the extent that new commitments to purchase such units will not raise the value of the holdings of such accounts to more than ten percent of the market value of the total portfolio being managed or five percent of the total net asset value of any such commingled real estate investment account at the time the commitment is made. Should market activity or Plan withdrawals increase the proportion which the value of units of participation in real estate accounts bears to the value of the portfolio and the value of the account totals to more than ten and five percent respectively, it will not be necessary to liquidate any units of participation in the real estate accounts, but no new units should be purchased while such overage(s) exist.

20. No investment should be made which will cause the Retirement Plan Trust to be subjected to tax on unrelated business income imposed by Sections 511-514 of the Internal Revenue Code.

21. Investment managers are authorized in their sole discretion and judgment to exercise voting rights in securities held in the portfolios which they manage.

22. There should be no purchase of non-dollar denominated securities, nor dollar denominated securities trading abroad which are not registered with the US Securities and Exchange Commission. Limited holdings of the following securities will be permitted, provided that the cumulative market value of these securities will not at any time exceed twenty percent of the market value of the total portfolio being managed:

(a) securities trading on a US stock or bond exchange, or listed by the National Association of Securities Dealers, which are categorized as 'foreign' by the respective self-regulatory organization, and

(b) dollar denominated securities of foreign issuers registered with the US Securities and Exchange Commission.

23. (a) The effective duration of the fixed income portfolio, including any net futures position, should at no time exceed 150 percent, or be less than 67 percent, of the Lehman Bros. Aggregate Bond Market Index.

(b) Notwithstanding any prohibition to the contrary, an investment manager may, with the Committee's prior authorization, use interest rate futures contracts subject to the limitation in (a) above and the following two general limitations:

1. Interest rate futures contracts should be purchased or sold through the Chicago Board of Trade, Chicago Mercantile Exchange, or an organization of similar regulatory status, size and capitalization.

2. The net futures position should at no time exceed 15% of the market value of the advisor's fixed income portfolio.

24. Notwithstanding any prohibition to the contrary, an investment manager may, with the Committee's prior authorization, use stock index futures contracts subject to the following two general limitations:

    1. Stock index futures contracts should be purchased or sold through the Chicago Board of Trade, Chicago Mercantile Exchange, or an organization of similar regulatory status, size and capitalization.

    2. The net futures position should at no time exceed 15% of the market value of the advisor's equity portfolio.

25. (a) Consistent with *Guidelines Nos. 8 and 9*, there should be no purchase of securities that derive their value from a formula that adjusts the coupon rate or terminal value to a multiple of some index return, or the difference between a stated rate and a multiple of an index.

    (b) Limited holdings of the following securities will be permitted, provided that the cumulative market value of these securities will not at any time exceed 10% of the market value of the advisor's fixed income portfolio: Interest-only securities, principal-only securities, inverse floating securities and unleveraged structured notes. The Committee will from time-to-time add to or delete from this list.

26. There should be no purchase of securities which are not registered with the US Securities and Exchange Commission excepting commercial paper and certain limited holdings of fixed income securities issued under Rule 144A. Notwithstanding any prohibition to the contrary, an investment manager may purchase fixed income securities issued under Rule 144A provided that the cumulative market value of these securities will not at any time exceed ten percent of the total market value of the fixed income portfolio.

27. Investment managers should certify to the Committee each year in writing that:

    (a) the firm complies with these *Investment Objectives and Guidelines*; and

    (b) the firm complies with the *Risk Standards for Institutional Investment Managers and Institutional Investors*[6], or identifies and provides a rationale for any exceptions.

REVIEW PROCESS

The investment objectives represent the longer-term strategy and goals for investment of the funds of the Retirement Plan. Performance will be reported by the investment managers to the Committee on Investment Performance on a quarterly

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[6] Risk Standards Working Group, *Risk Standards for Institutional Investment Managers and Institutional Investors* (November 12, 1996, as revised).

basis. The investment managers will also meet with the Committee on Investment Performance no less frequently than annually to review the investment managers' performance and investment strategy relative to these objectives. Against this background, the objectives will be reviewed periodically, i.e., at least once every three years, and revised or confirmed as appropriate.

The investment guidelines will be reviewed annually and revised or confirmed as appropriate.

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RESPONDS TO (D) ON

PAGE 2 OF

SCARBOROUGH LETTER

FUNDING REQUIREMENTS OF THE RETIREMENT PLAN IF INVESTED ENTIRELY IN TREASURY SECURITIES (1988 - 1998)
(in thousands)

DATE	ACTUAL INVESTMENTS (1) MARKET VALUE OF ASSETS	ACTUAL INVESTMENTS (2) VALUATION ASSETS AVERAGING METHOD	(3) INTERMEDIATE BOND MARKET VALUE OF ASSETS	(4) TOTAL BENEFIT OBLIGATION FUNDING ASSUMPTIONS	(5) ACCRUED LIABILITIES BASED ON ENTRY AGE FUNDING METHOD	(6) UNFUNDED ACCRUED LIABILITIES VALUATION ASSETS (5 - 2)	(6) UNFUNDED ACCRUED LIABILITIES BOND MARKET VALUE (5 - 3)
Jan-88	$ 1,701,035	$ 1,522,140	$ 1,701,035	$ 1,550,949	$ 1,142,468	$ -	$ -
Jan-89	1,851,164	1,652,262	1,731,542	1,668,114	1,223,642	0	0
Jan-90	2,205,348	1,845,261	1,861,478	1,788,233	1,317,694	0	0
Jan-91	2,184,157	1,979,072	1,982,566	2,057,929	1,555,488	0	0
Jan-92	2,744,882	2,195,906	2,204,084	2,239,439	1,701,538	0	0
Jan-93	2,853,261	2,411,806	2,276,836	2,400,951	1,824,315	0	0
Jan-94	2,973,060	2,625,699	2,441,759	2,532,826	1,933,884	0	0
Jan-95	2,900,319	2,755,207	2,225,272	2,712,770	2,101,317	0	0
Jan-96	3,635,593	3,043,215	2,484,050	3,232,092	2,492,523	0	8,473
Jan-97	4,156,964	3,325,587	2,422,391	3,375,596	2,622,045	0	199,654
Jan-98	5,030,644	4,024,515	2,594,005	3,503,885	2,746,397	0	154,392

(1) As reported in Buck Consultants' annual valuation of the Plan.
(2) For actuarial funding purposes, the actuary uses a 5-year moving average methodology for determining Plan asset values.
(3) Assuming Plan assets in 1988 -- $1.7 billion -- were invested in intermediate U.S. government bonds. Returns on this intermediate U.S. government bond portfolio were obtained from Ibbotson Associates "Stocks, Bonds, Bills and Inflation" yearbook.
(4) Benefit Obligations from Buck Consultants' annual valuation of the Plan.
(5) Accrued Liabilities from Buck Consultants' annual valuation of the Plan.
(6) Reflects funded status of the Plan using asset values as determined in Buck Consultants' annual actuarial valuation of the plan as well as an estimate of the Plan's funded status if investment returns since January 1, 1988 paralleled those invested in United States government bonds.

TOTAL P.03

Enclosure

Analysis of the Funding of the CSRDF
Assuming the Same Investment Returns
as the Federal Reserve Pension Fund

Table 1, below, shows what the liabilities of the Civil Service Retirement and Disability Fund (CSRDF) would be if the assets were invested in a balanced portfolio of private sector securities starting in 1988, and had earned the same investment returns as the Federal Reserve pension fund. According to the 1998 annual report of the Federal Reserve retirement plan, about 66 percent of the assets are invested in common stocks, and approximately 20 percent are invested in U.S. Treasury and government agency securities. For purposes of simplification, we will refer to Federal Reserve retirement fund investments as "private sector securities," even though some of them actually are in U.S. government securities.

Table 1 assumes that the assets in the CSRDF at the end of 1987, which amounted to $178.7 billion, were transferred to private sector securities at that time, and started to earn the same investment return as the Federal Reserve pension fund. It also assumes that any contributions over and above those needed to pay benefits, starting in 1988, were invested in this manner. If the $178.7 billion in assets at the end of 1987 were invested entirely in private sector securities. this amount would have been considered a Budget outlay. The total Budget outlays over the period 1988 through 1998 would have increased by $178.7 billion, plus interest costs on the debt needed to finance these purchases.

Assuming these investments in private sector securities, the market value of the assets in the CSRDF at the end of 1998 would have been $847.0 billion, rather than the actual value of $457.1 billion. In determining the actuarial liabilities of its pension fund, the Federal Reserve values the assets using a 5-year averaging method. Under this method, the assets of the CSRDF at the end of 1998 would have been $677.6 billion, rather than the market value of $847.0 billion.

As was mentioned, this analysis assumes that the contributions to the CSRDF over this period did not change from the actual, historical amounts. However, under the current statutory funding provisions for CSRS, the government contributions would have been reduced if the assets had been greater. Also, the normal cost under FERS would have been lower, as a consequence of the assumption of higher investment returns expected from the private sector securities. Assuming this reduced level of funding, the total government contributions would have been approximately $56.3 billion less over the 1988 through 1998 period. Also, as a result of these lower contributions, the assets in the fund at the end of 1998 would have totaled $738.3 billion, rather than $847.0 billion that would have resulted if the government contributions had remained the same as under current law.

Table 1 shows the total present value of future benefits (which is sometimes referred to as the "total benefit obligation") in column (4), which represents the liability for all future benefits, including benefits attributable to both past and future service. It also displays the actuarial accrued liability in column (5), which is the present value of future benefits, less the present value of expected future normal cost contributions. This measures the liabilities that have accrued to date. These two measures of the actuarial liabilities were determined using the current economic assumptions.

Finally, Table 1 shows the unfunded liability, which is equal to the actuarial accrued liability, less the value of the assets in the fund. At the end of 1998, we projected the unfunded liability of the CSRDF to be $501.0 billion, under current law. The table also shows what the unfunded liability would be if the assets had been invested in private sector securities, and were valued using the 5-year averaging method that is used by the Federal Reserve. In this case, the unfunded liability would be $280.5 billion, rather than $501.0 billion. However, as was mentioned, the total Budget outlays would have been higher by $178.7 billion over this 11-year period, plus interest on the debt to finance the initial private sector securities purchased.

Table 2 shows the same information that is presented in Table 1, for CSRS and FERS separately. (Due to rounding, the results for CSRS and FERS do not add up exactly to the results shown in Table1.) For FERS, the 1998 figures show that the assets exceed the actuarial accrued liability by $11.9 billion under current investment practices. This is shown as an unfunded liability of -$11.9 billion. If the assets had been invested in private sector securities, they would have exceeded the actuarial accrued liability by $39.3 billion.

Table 1

Funding of the CSRDF if the Assets were Invested Private Sector Securities, Assuming the Same Investment Return as the Federal Reserve Pension Fund

	Investments in Private Sector		Treasury Bonds			Unfunded Liabilities	
End of Fiscal Year	Market Value of Assets (1)	Average Value of Assets (2)	Actual Value of Assets (3)	Present Value of Future Benefits (4)	Actuarial Accrued Liability (5)	Average Value of Assets (5)-(2)	Actual Value of Assets (5)-(3)
1988	202.1	162.5	197.1	980.9	705.4	542.9	508.3
1989	248.6	198.9	216.7	1024.8	765.0	566.1	548.3
1990	255.7	210.2	238.0	1068.8	806.7	596.5	568.7
1991	330.8	264.6	261.6	1125.8	855.4	590.8	593.8
1992	357.2	285.7	288.4	1158.6	888.1	602.4	599.7
1993	386.2	316.9	317.4	1086.6	857.5	540.6	540.1
1994	390.5	345.6	344.3	1110.2	884.9	539.3	540.6
1995	503.0	402.4	371.3	1140.0	917.1	514.7	545.8
1996	589.5	471.6	398.9	1120.0	911.3	439.7	512.4
1997	716.4	573.1	427.5	1137.3	933.1	360.0	505.6
1998	847.0	677.6	457.1	1162.6	958.1	280.5	501.0

Honorable Joe Scarborough

Table 2

Funding of the CSRDF if the Assets were Invested in Private Sector Securities, Assuming the Same Investment Return as the Federal Reserve Pension Fund Shown For CSRS and FERS Separately

CSRS

	Investments in Private Sector		Treasury Bonds			Unfunded Liabilities	
End of Fiscal Year	Market Value of Assets (1)	Average Value of Assets (2)	Actual Value of Assets (3)	Present Value of Future Benefits (4)	Actuarial Accrued Liability (5)	Average Value of Assets (5)-(2)	Actual Value of Assets (5)-(3)
1988	193.9	155.9	189.1	906.9	691.8	535.9	502.7
1989	234.5	187.6	204.4	945.0	747.2	559.6	542.8
1990	237.1	194.9	220.3	974.6	783.4	588.5	563.1
1991	301.0	240.8	237.3	1010.3	825.0	584.2	587.7
1992	319.6	255.7	256.4	1030.6	851.4	595.7	595.0
1993	339.7	278.7	276.7	961.0	815.0	536.3	538.3
1994	337.5	298.9	294.3	972.4	835.0	536.2	540.7
1995	427.5	342.0	311.4	986.0	857.8	515.8	546.4
1996	493.9	395.1	329.0	962.0	847.2	452.1	518.2
1997	592.5	474.0	344.1	966.0	859.3	385.3	515.2
1998	692.7	554.2	360.6	972.9	873.5	319.3	512.9

FERS

	Investments in Private Sector		Treasury Bonds			Unfunded Liabilities	
End of Fiscal Year	Market Value of Assets (1)	Average Value of Assets (2)	Actual Value of Assets (3)	Present Value of Future Benefits (4)	Actuarial Accrued Liability (5)	Average Value of Assets (5)-(2)	Actual Value of Assets (5)-(3)
1988	8.2	6.6	8.0	74.0	13.6	7.0	5.6
1989	14.0	11.2	12.3	79.8	17.8	6.6	5.5
1990	18.6	15.3	17.7	94.2	23.3	8.0	5.6
1991	29.8	23.9	24.3	115.5	30.4	6.5	6.1
1992	37.6	30.1	32.0	128.0	36.7	6.6	4.7
1993	46.6	38.3	40.7	125.6	42.5	4.2	1.8
1994	53.1	47.0	50.0	137.8	49.9	2.9	-0.1
1995	75.5	60.4	59.9	154.0	59.3	-1.1	-0.6
1996	95.9	76.7	69.9	158.0	64.1	-12.6	-5.8
1997	124.4	99.5	83.4	171.3	73.8	-25.7	-9.6
1998	154.9	123.9	96.5	189.7	84.6	-39.3	-11.9

Mr. SCARBOROUGH. We are down to 5 minutes and would like to adjourn, and then go to markup.

Any objections?

Ms. NORTON. No objection.

Mr. SCARBOROUGH. Well, we would like to thank you all.

Let me say very quickly that I concur with the gentlelady. She was put in an extremely difficult position in the 105th Congress on the so-called "bail-out," so I certainly concur with everything you said regarding the D.C. situation.

I want to thank both of our witnesses for coming and testifying before us today. It certainly was insightful, and we will leave the record open for 2 weeks and send any further questions we may have to you.

Thank you, and this hearing is adjourned.

[Whereupon, at 11:40 a.m., the subcommittee adjourned.]

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