State Pension Review Board
Actuarial Committee Meeting
Minutes
April 22, 2014

1. **Meeting called to order**

The second meeting of 2014 of the State Pension Review Board (PRB) Actuarial Committee was called to order by Chair Bob May on Tuesday, April 22, 2014, at 10:00 a.m. at the Employees Retirement System of Texas (ERS) in Austin, Texas.

2. **Roll call of Committee members**

Board Members Present:
Robert M. May
Andrew W. Cable
Keith W. Brainard

3. **Approval of the January 29, 2014 Committee meeting minutes**

Chair May entertained a motion to suspend the reading of the Minutes of the PRB Actuarial Committee meeting held January 29, 2014.

Motion made by Mr. Andrew Cable, seconded by Mr. Bob May that the PRB Actuarial Committee suspend the reading of the Minutes of its meeting held on January 29, 2014.

MOTION CARRIED UNANIMOUSLY

4. **Introduction of new Committee member**

Chair May welcomed Mr. Keith Brainard to the Committee.

5. **Discuss and consider the study of the financial health of public retirement systems in the state as required by Section 7 of House Bill 13 (83rd Texas Legislature)**

Mr. Hanson reviewed an updated report outlining the study of the financial health of public retirement systems in Texas. The financial health study is a requirement from House Bill 13 for the PRB to conduct a study, with a preliminary report due to the Legislature by September 1, 2014. Any system covered in the report will be provided a reasonable opportunity to review those recommendations and submit a response to the PRB. The final report is due to the Legislature not later than December 31, 2014. Mr. Hanson reviewed a current listing of the plans amortization periods based on the PRB *Guidelines for Actuarial Soundness.* Forty years is the minimum acceptable amortization period under the *Guidelines,* with the recommended range being 15 – 25 years. At the request of the Chair, staff was asked to examine the actual amortization periods based on the actual contribution rates. Mr. Hanson stated that there are currently 28 systems identified with an amortization period of greater than 40 years, 36 plans that are between 25 and 40 years, and 29 plans that are meeting or exceeding the recommended range.

Mr. Hanson reviewed two charts included in the meeting packet showing the asset performance and asset value for public retirement systems in Texas going back prior to the downturn from 2007 through 2012. Mr. Hanson stated that many of the 2013 financial reports will be submitted to the PRB over the summer, and at that point the 2013 data will be updated. In reviewing the few reports that have been submitted to the PRB, the asset values have continued to increase. There were significant losses in 2008 and 2009; however, Texas public retirement systems asset values have been steadily increasing overall.

Mr. Hanson stated that as of the last committee meeting in January, staff has begun to examine the overall history of some of the underfunded plans. Staff has currently reviewed 20 of the 28 underfunded plans and examined financial, benefit, demographic, and actuarial information. Under the contribution history review, the average percent of the ARC, based on a 40 year amortization period, that was paid between the years 2000 and 2006 is 86 – 87 percent, and the average percent of the ARC, based on a 30 year amortization period, that was paid between 2007 and 2013 is also 86 – 87 percent. The current average shortfall as a percent of pay is 5.41 percent for the 30 year total contribution rate. When examining the financial history over the last ten years, staff determined that the average rate of investment return of the 20 systems reviewed is just over 7%, which is higher than anticipated, given the significant market downturn in 2008 and 2009. The average annual cash flow (Dan? contributions less benefits) was identified at -2.17%. When examining the asset to liability growth for these plans, since the year 2000 it was identified that for every dollar of actuarial accrued liability, there has been fifty cents of assets added. Mr. Hanson stated that staff has additionally reviewed some of the benefit increase history and noticed that 87% of the systems reviewed have increased benefit multipliers, 65% added or enhanced COLAs, 24% provide automatic compound COLAs, and 90% have added or enhanced DROP provisions. Lastly, staff examined the current demographics on average of these systems and the active to retired ratio is 1.39 to 1.00.

Mr. Brainard requested that the staff review the chart showing the aggregate rates of return for Texas actuarially funded plans. Mr. Hanson stated that the chart presents the rates of return based on the PRB database calculations from the plans annual financial reports, and stated that the numbers reflect the average across all plans for those years. Mr. Brainard asked whether the years represent calendar years or fiscal years. Mr. Hanson stated they reflect fiscal years, and mentioned that a reason the numbers may not reflect a steeper decline is due to the various fiscal year end-dates.

Mr. May suggested adding a footnote explaining the various fiscal years and how they are different.

In reference to the contribution history review section of the report, Mr. Brainard asked if the averages are weighted or referenced every system as one. Mr. Hanson stated that the averages referenced each individual system. Mr. Brainard stated that ERS has not been receiving its ARC as an example, and requested if the same figure could be calculated to capture a weighted average, noting that he would expect the average to be much lower as he suspects ERS is getting much less than the Teacher Retirement System (TRS). Mr. Hanson stated that TRS increased contributions during the last legislative session.

Mr. Stacy stated that because the statewide plans relied so much on the averages of the state, would there be a benefit in analysis to have a separation between statewide plans and local plans or non-state-wide plans.

Mr. May stated that there is additional work to be done and that staff is looking historically at the data received from each individual plan. He stated that the Texas County and District Retirement System (TCDRS) will be counted as a whole system, and noted that the Texas Local Firefighters Retirement Act (TLFFRA) plans such as Beaumont, Tyler, or Midland for example will be examined individually.

Mr. Hanson stated that in the *Guide to Public Retirement Systems*, staff has identified systems based on the statute that governs them for example, statewide systems were grouped together and the Vernon Civil Statute Systems which include the larger local systems (Austin, Dallas, Houston, and El Paso) were grouped together. He stated that it may be helpful to group systems this way as it may be helpful to the individuals receiving this report.

Mr. May agreed that it would be a good idea to start grouping the systems.

Mr. Brainard stated that he believes that both Texas Municipal Retirement System (TMRS) and TCDRS produce reports specifying the funding conditions for each of their employer members, and suggested including that sort of information as an appendix to this report.

Mr. May agreed with Mr. Brainard's suggestion to include this information to the report.

Mr. Hanson stated that the PRB typically publishes the *Guide to Public Retirement Systems* at the beginning of each session which is a comprehensive report of all the systems in the state. He commented that this report would go well with the *Guide* as a dataset to support it as it would be helpful to those receiving it.

In regards to preliminary trends that have been identified in systems with inadequate contribution rates, Mr. Brainard asked if the idea is to continue to apply the same type of questions to the rest of the systems.

Mr. Hanson replied yes, and the plan is to work our way down on the amortization period from the largest to the smallest.

Mr. Brainard asked if the PRB plans to get all of fiscal year 2013 data for all or most of the systems.

Mr. Hanson stated that the PRB may not receive all the information in time for the August board meeting as many systems will submit their information at the end of July; however, all the data will be received by the time the final report is due to the Legislature in December.

Mr. May asked if the data would include TRS and ERS.

Mr. Hanson stated that TRS and ERS data is usually released by the end of November, and expects to have the most current information for all the plans by December, 2014 for the final report. Staff has been contacting the plans informing them that the PRB would like to have the most current information on their system presented in the final report.

House Bill 13 also added the Investment Returns and Assumptions Report as a new reporting requirement for systems, and Mr. Hanson stated that the PRB has started to receive those reports which are due at the same time as the annual financial reports so there will be updated return information from a lot of the systems available.

Mr. Brainard stated that the outline reflects that the average active to retired ratio will vary significantly depending on whether it is a public safety plan or not, and asked how many of these plans can be clearly distinguished as a public safety plan versus not a public safety plan.

Mr. Hanson stated that most plans are clearly delineated to public safety and not public safety, stating that there are a handful that includes fire, police, and civilian all in the same plan, for example the Fort Worth Employees Retirement System.

Mr. May stated that there are 41 TLFFRA systems, and explained that TLFFRA refers to a section of state law that is referred to as an acronym for Texas Local Firefighters Retirement Act.

Mr. Brainard stated that it is a bigger concern to have a much lower ratio for a non-public safety plan.

Mr. Hanson stated that there are only a few systems that include both public safety and civilian within their plan; however, in most plans it can be identified which ones are strictly public safety and break out those numbers and compare them to civilian.

Mr. May stated that when he first reviewed the analysis of the actuarial valuations reports, where they are ranked in order of the length of their amortization period, it caught his attention that there are a number of thirty year amortizations. He stated that in some instances, the thirty year was the amortization period that would be achieved if the contribution rate was increased to the level the actuary had recommended, not what was actually contributed. He further stated that if you were actually contributing two-thirds as much as you should be, you would be at an infinite amortization period in terms of a best estimate based on what you have actually contributed over the last several years. He noted that he felt like that was a clear inconsistency in the report.

Mr. Moore stated that the report has been updated to reflect the changes.

Mr. Hanson stated that there have been additional changes, stating that the updated actuarial valuation reports include additional data points as well as the accrued liability, the covered payroll, and the unfunded accrued liability as a percent of payroll. Additionally, there have been subtotals added based on the same grouping, the grouping of plans over 40, those between 25 and 40, and those less than 25.

Mr. Brainard asked if it would be possible to include a table containing information informing the committee about the additional cost as a percentage of the payroll needed to bring each plan into an amortization period of 25 – 30 years.

Mr. May stated that there is a lot work to this project and it will be important to look historically based on what the systems have already done, and not move in a different direction. Even though the GASB 30-year amortization period goes away as a funding suggestion, the 30-year amortization period remains as a reasonable proxy for the PRB *Guidelines* even though the *Guidelines* now state 15 - 25 years is preferred instead of 30 years.

Mr. Hanson stated that some systems report 25, 30, and 40 year rates in their actuarial valuations, but most systems do not. One of the recommendations staff has reviewed as GASB is moving away from recommending funding is whether or not the board and the committee is recommending disclosure of 25, 30 or 40 years in the report as a funding standard. The information is not always clear and not always disclosed up front and it may be more difficult with GASB moving away from funding disclosure. Mr. Hanson stated that some of what staff has identified for the underfunded plans is that even if they are insufficient contributions over a long period of time, regardless of benefit levels, you can eventually become severely underfunded, and having disclosure of what a sufficient contribution rate would be, along with what the actual rate is may be a recommendation that would be helpful going forward.

Mr. Brainard inquired whether Mr. Hanson was referring to a funding period or a measuring period. Mr. Hanson clarified that he was referring to a measuring period; what would be the total rate to be at 25 years for system 'A'.

Mr. May stated that a future project the committee has discussed was in terms of a timetable. After the regular session ends in the summer of next year, he commented that it would be a good time to begin to review the *Guidelines for Actuarial Soundness* as well as to review what various actuarial associations are recommending in regards to funding standards.

Mr. Brainard raised a question concerning the projected dollar amount shortfall column included in the chart. Using ERS as an example, he asked whether the $639,451,477 means that ERS needs an annual contribution of $639,451,477 in addition to what it has been receiving.

Mr. Moore stated yes that is correct, and noted that the employee contribution rate of 6.60% reflects the current fiscal year and is scheduled to go up to 7.5% under legislation.

Mr. May asked how many plans have already scheduled rate increases that are seen in statute.

Mr. Hanson stated that different systems have different funding policies.

Mr. May stated that in situations where there is strong funding governance such as TMRS and TCDRS, the trustees through their actuaries set the rate for city X, and that is what they contribute. He stated that he believes it is true that all cities in TMRS and all counties and districts in TCDRS annually adjust their rate to what the actuary has determined. On the other hand, Mr. May stated that there is strong governance at the constitutional minimum of 6% for teachers and state employees, but there is a biennial judgment by the legislature as to what the rate will actually be when it is higher than 6%.

Mr. Hanson stated that the chart is called the projected 30 year shortfall because it is a rough estimate, but the intention is to make sure the numbers are consistent with what the plans are reporting. ERS and TRS will likely have updated figures going into the next session, and Mr. Hanson commented that staff will work with the systems to provide the most accurate information of what the actual rates are and what they are scheduled to be.

Mr. May noted that in reference to any gray areas, footnotes should be included.

Mr. Hanson stated that these projections are based on current information that PRB staff currently has, and updated information is expected from most systems over the next several months leading to December.

Mr. Ewing had a question regarding the best practices section of the report and asked if the Committee envisions the best practices as being recommendations or a series of options.

Mr. Hanson stated that his initial discussions with members of the Legislature and their staff in trying to get an interpretation of what the expectation of this report would be, is that there would be some specific recommendations from the board, specific recommendations regarding good pension management and sound funding policy.

Mr. Brainard asked what the expectation was as far as including an assessment of the causes of the severe funding shortfalls. For example, will the report address the fact that ERS is in its current condition predominately because the contribution rates have consistently been less than what was actuarially recommended.

Mr. Hanson stated that the expectation is to identify the general trends that most of the underfunded plans are receiving over a period of time, and to present that history.

Mr. Brainard asked if there is wide disparity in terms of investment outcomes.

Mr. Hanson stated that in the information staff has analyzed, there is some disparity.

Mr. Brainard suggested that in cases where it is fairly easy to identify the primary causes of the funding shortfall, it should be included in the report.

Mr. May agreed with Mr. Brainard's suggestion.

Mr. May stated that during a recent conference call with the American Academy of Actuaries public plans sub-committee, the overall sense of the actuaries on the call was that the two biggest problems with public sector plans are the high level of contributions to the plan because employers are reluctant to pay those high levels, and if they don't pay them, then there is a shortfall because they are contributing less than the ARC. The second most serious concern was the annual or biennial volatility of the employer contribution rate because if it fluctuates a lot, it makes it difficult for public employers to budget the actuarially determined contribution.

Mr. Brainard suggested identifying a handful of major categories causing plan underfunding, and establishing thresholds indicating whether it is a material cause that is driving that plans financial condition.

Mr. Hanson stated that staff is currently building a dataset of that sort, and one of the issues being worked through is determining what the categories would be. He stated that 20 of the 28 systems that are over 40 years have been examined and expects to get the rest examined by the May meeting.

Mr. Brainard stated that each plan sponsor's payroll amount is a good proxy, but it does not tell everything and having an analysis like that could be very insightful. He further stated that with the portion of the total state budget that ERS represents, it looks like an outsized problem and suspects that if the number was to be looked at in the context of total state finances and the amount of resources available in the state and so on, it is a much smaller problem than it appears to be. He suggested starting with the bigger plans at the state level and working down.

In reference to the comment regarding measuring the differences in overall investment returns, Mr. Stacy commented that he questions whether it may be more effective to look at what the actual return history is relative to the assumption return history as different plans have different funding strategies to meet different objectives. Those strategies may not necessarily mean that they all have the potential to make an 8, 9, 12, or 20 percent return because of their underlying funding mechanism they need.

Mr. Brainard stated his agreement with Mr. Stacy's comment.

Mr. Hanson stated that staff wanted to point out that the information they are using on the data point is a 10-year rate which is the rate that is most easily reported, and is part of the PRB 1000. He stated that he would caution against leading someone to believe that if you had 10 years where you were a bit lower than your return, than that was ultimately the problem, although it is something to be aware of and may be information to include so that the reader can understand the difference.

Mr. Brainard stated that his main interest is to identify potential financial problems, and if the plan is consistently falling short of its objective, there is an issue.

Mr. Lawson stated that the realm of the issue is the amount of risk, and how efficiently that risk is utilized in order to achieve a certain rate of return. If examining a typical 60/40 pension allocation, when delving into the risk allocation, what is generally learned is that about 90 – 95% of the risk is associated with equities. Whenever an event such as 2007 and 2008 occurs, and a tail event follows, that is when all of a sudden a system is crushed, and instead of being able to amortize the liability over a reasonable amount of time, you are all of a sudden talking about an infinite time-period to amortize the unfunded liability.

Mr. Hanson stated that in reference to pension systems that may be in a position where they might be at risk of not meeting their long-term obligations, it is important to understand the different range of scenarios so the board of trustees and the sponsor are aware of the impact of different return assumptions.

Mr. May asked about the specific things that the Legislature has asked for regarding the Study.

Mr. Hanson stated that the specific language asks for the Board to conduct a study of the financial health of public retirement systems in the state, including each system's ability to meet its long-term obligations considering the contributions, benefits, and investments made under the system.

Mr. May stated the importance of paying attention to what the *Guidelines for Actuarial Soundness* are, and not to move far away from them as it may be harder to defend the report.

Mr. Hanson stated that the Legislature has additionally asked the Board to submit a written report containing the findings of the study conducted, as well as the Board's recommendations regarding how a public retirement system may mitigate the risk of not meeting the system's long-term obligations. There is a period for the systems to comment once the preliminary report is released in September, and those systems are offered a reasonable opportunity to comment. The final report is due December 31st and will include the recommendations and a copy of the responses provided by the systems.

Mr. Stacy asked if the report is able to take an aggregate of historical data over multiple actuarial reviews of systems.

Mr. May stated that one of the real strengths of the report is that the PRB has developed a large body of history of experience going back to the late 1990s and taken key items of information out of valuation reports while looking for trends.

Mr. Hanson stated that the expectation of what staff will do going into the May 14th Board meeting is to take these discussion points, flesh out some of the information, and try to provide additional background on some of the issues that were raised and obtain answers for the committee.

Mr. Hanson stated that staff would look at Committee members summer schedules in order to plan in advance a couple of summer committee meetings.

6. <u>Adjournment</u>

Chair May thanked the Committee and the audience for their participation at the meeting. With the business of the Committee completed, Chair May adjourned the meeting at 11:45 a.m.

In Attendance:

Staff:

Chris Hanson
Daniel Moore
Reece Freeman
Steve Crone
Bryan Burnham
Anne Benites

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Guests:

Mike Ewing, Employees Retirement System of Texas
Eddie Solis, Texas Association of Public Employee Retirement Systems
David Stacy, Midland Firemen's Relief and Retirement Fund
John Lawson, Houston Police Officers' Pension System
Mark Fenlaw, Rudd and Wisdom
Pattie Featherston, Legislative Budget Board

Robert M. May

Chair Robert M. May