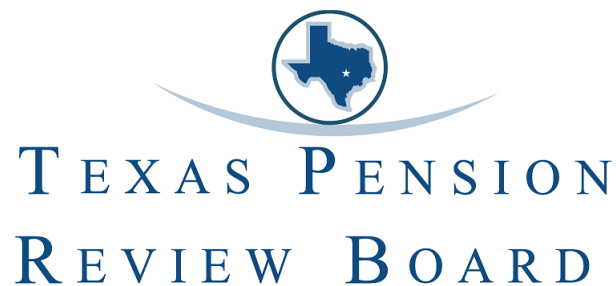


Recommendations to the 87th Legislature

NOVEMBER 2020



INTRODUCTION

[Texas Government Code Section 801.203](#) requires the Pension Review Board (PRB) to submit a public report each biennium to the Governor and legislature that provides detail on the agency's work. The report includes recommendations of any legislation relating to public retirement systems adopted by the PRB in accordance with the statutory mandate.

On November 30, 2020, the PRB submitted to the Governor and legislature the [2019-2020 Biennial Report](#), which was published online for public access. The report contained the following documents detailing the PRB's recommendations for changes to the [Funding Policy](#) and [Funding Soundness Restoration Plan](#) (FSRP) statutes, as well as the [Investment Practices and Performance Evaluation](#) statute.

PRB Legislative Recommendations
Funding Policy and Funding Soundness Restoration Plan

Funding policy and FSRP requirements are currently separate and do not tie together to form a continuum of funding support to plans and sponsors. The funding policy requirement, enacted in 2019, requires plans to adopt a funding policy targeting full funding. The FSRP statute, enacted in 2015, requires plans and their sponsors to adopt a remediation plan if the unfunded liability cannot be amortized over 40 or fewer years.

Now that plans have funding policies, they have long-term plans to achieve full funding. However, the remediation plan requirement for plans that face serious funding shortfalls operates independently of the newer funding policy mandate and does not require plans to target full funding over a closed period in line with *PRB Funding Guidelines*.

Ideally, funding policies and funding restoration plans should work together to provide a clear path toward full funding (funding policy), and when negative experience impedes funding progress, provide a mechanism to get back on track (restoration plan). To provide an effective continuum of funding support for Texas pension plans, the FSRP, which is designed to quickly shore up dramatic funding problems, should tie back to the funding policy, which is designed to prevent funding deficiencies.

The Board has approved and is recommending the following, for consideration by the Legislature, to improve current funding policy and funding soundness restoration plan statutory requirements.

Potential Change to Funding Policy Requirements

1. **Sponsor involvement.** Add the sponsor to the funding policy requirement so that both the pension board and plan sponsor have ownership in the plan to achieve full funding rather than only in the remediation plan once funding problems require immediate action. Specifically, require the plan and sponsor to jointly develop the funding policy.

Potential Changes to FSRP Requirements

2. **Increase sponsor accountability and tie funding policy and FSRP together**

Funding policy revision. Incorporate the funding policy upon trigger of FSRP. If an FSRP were triggered, the plan and sponsor would be required to adopt an FSRP and revise the funding policy together to ensure both parties are involved in long-term improvement. For FSRP plans, the revised funding policy should include a detailed plan to share the cost of unexpected actuarial losses that could derail progress toward the FSRP goal.

Sponsor adoption. Require the sponsor's governing body (e.g., city council) to adopt the FSRP through resolution to ensure full sponsor involvement and ownership.

3. Update threshold, target and trigger

Lower threshold and target to 30 years. Bring the FSRP threshold and target in line with *PRB Guidelines* and other standard-setting bodies by changing 40 years to 30 years (*PRB Guidelines* upper bound).

Tiered trigger and phase in of lower threshold. (Effective 9/1/2025) Trigger the FSRP requirement immediately for:

- a. plans that receive an AV with the amortization period **over 40 years**; and
- b. plans that receive an AV with an amortization period **between 30 - 40 years and a funded ratio lower than 65%**.

For plans that receive an AV with an amortization period **between 30 - 40 years and a funded ratio of 65% or above**, the FSRP is triggered after three consecutive annual AVs, or two consecutive AVs if the systems conduct the valuations every two or three years. 30-year amortization period target would not be expected to be achieved until 9/1/2025.

Credit for reforms already made. (Effective 9/1/2025) Plans (and sponsors) that receive an AV with an amortization period between 30 – 40 years should not become subject to the FSRP requirement if:

- they are implementing an FSRP formulated prior to 9/1/2025; or
- they are implementing a contribution rate structure that utilizes, or will ultimately utilize, the ADC; **and**
- the AV indicates they are on a path towards full funding.

4. Update timelines and consequences if original FSRP is not working

Timeframe for developing FSRP. Allow **2 years**, rather than 6 months, for the completion of the FSRP, but also require progress updates at 1 year and at 18 months. Progress updates should include a draft plan or changes under consideration.

Future actions. Clarify that FSRPs may not include items requiring future action such as votes of the membership and that the FSRP must memorialize actions taken. FSRPs may include contribution schedules for future increases.

Shorter implementation timeframe. Remove 10-year period to reach target and require plans to achieve 30 years or less no later than 2 years from the triggering valuation.

Failure to achieve FSRP goal. If a plan and sponsor become subject to a second FSRP within a period of 10 years from adoption of the first FSRP, the second FSRP and revised funding policy shall include stricter requirements for funding restoration, such as:

- a. risk-sharing mechanisms;
- b. an ADC-based contribution structure;
- c. adjustable benefit or contribution mechanisms;
- d. a lower amortization period target: 10-25 years (per the *PRB Funding Guidelines*)

5. Update required documentation

- Require FSRPs to provide an aggregate analysis of multiple changes specifically showing how the combined impact of the changes in the FSRP would result in meeting the statutory requirements. The analysis must include an actuarial projection that shows the unfunded liability decreasing to zero within the required time period. The plan and sponsor should share the cost of the analysis.
- Clarify that any assumptions must be made in accordance with ASOPs.

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PRB Legislative Recommendations
Investment Practices and Performance Evaluations

LEGISLATIVE RECOMMENDATIONS

After the first comprehensive evaluations were completed in 2020, the PRB identified opportunities where some modifications to the statute may prove beneficial. Broadly, the PRB identified areas to refine the evaluation process and clarify the material that is included in an evaluation. These changes will help enhance transparency and strengthen investment practices, benefitting plan members, taxpayers, and local governments.

The Board has approved and is recommending the following for consideration by the Legislature:

1. Require evaluations to detail how the evaluator determined the need, or lack thereof, for any recommendations.

Goal. To evaluate the appropriateness, adequacy, and effectiveness of the retirement system's investment practices and performance and to make recommendations for improving the retirement system's investment policies, procedures, and practices.

Issue. It would be helpful to the systems if the existing law were clearer regarding which aspects of the evaluation should be communicated and how. In general, evaluations received included at least a high-level description of the existing "investment policies, procedures, and practices." When a recommendation was made, most evaluators justified the recommendation with an explanation where the existing approach fell short. However, when no recommendation was made, not all evaluators provided an explanation as to why existing practices are appropriate, adequate and/or effective.

Recommendation. Require evaluations to provide detail both when a recommendation is made and when no recommendation is deemed necessary, to enhance understanding of the investment decision-making process and help foster informed decision-making.

2. Require a formal review-and-comment process prior to publication of evaluation reports.

Goal. Evaluations are intended to offer an independent analysis of the pension system's practices and policies; ideally, they will prompt a thoughtful review of the system's practices and promote positive change, as appropriate.

Issue. In some cases, it is unclear whether systems have reviewed the evaluation and considered the recommended changes. In contrast, §802.1012(g) of the Texas Government Code requires a formal review-and-comment process for actuarial audits of certain retirement systems, making clear that the system has reviewed the results.

Recommendation. Statute should require a formal review-and-comment process for evaluation reports, modeled after the actuarial audit requirements outlined in Texas Government Code §802.1012(g). It would include:

- Requiring a substantially complete draft of the IPPE be submitted to the pension system's board prior to publication, providing an opportunity for discussion and clarification.
- Allowing the board, the opportunity to submit a written response to the firm acknowledging receipt and making comments or noting any anticipated changes in response to the report's findings.

- Including the response from the board in the final published evaluation, giving stakeholders insight into the impact of the evaluation on the system's practices.

3. Review and consider the feasibility of whether an independent firm conducting the evaluation should be a different firm from the one that helped the system develop its existing investment policies, procedures, and practices.

Goal. Under existing law, evaluations are to be conducted by an “independent firm,” which aims to provide a new perspective on the system's practices. Current law allows the firm selected to have an existing relationship with the pension system.

Issue. More than half of the evaluations were conducted by the system's current investment consultant—the firm that likely helped the system develop its existing investment policies, procedures, and practices. Investment Committee members noted, and the data appear to suggest, existing consultants may be less likely to identify areas for improvement if they were directly involved in the development of the existing practice.

Recommendation. A third-party consultant presents an opportunity for a full analysis of current investment processes, encompassing the work of the current investment consultant, which is not possible otherwise. The Legislature should consider the feasibility of precluding a firm that advised or advises the system on its investment policies, procedures, and practices from conducting the evaluation of those policies.

4. Require evaluators to identify its qualifications and potential conflicts-of-interest; codifying existing PRB informal guidance.

Goal. The current evaluation requirement was designed to allow for a fresh look at the investment practices and policies of pension systems to identify opportunities for improvement.

Issue. While the PRB's informal guidance suggests that evaluations make specific disclosures, some evaluations did not clearly identify what firm performed the evaluation, the qualifications of the evaluator, or certain potential conflicts-of-interest. This makes it more difficult for members, taxpayers and other stakeholders to assess the evaluation's efficacy.

Recommendation. IPPEs should contain certain disclosures about the evaluator, including:

- The evaluator's qualifications;
- The nature of any relationship between the evaluator and the plan, and an acknowledgement of potential conflicts-of-interest due to any existing relationship;
- Identification of any remuneration received by the evaluator;
- Acknowledgement the firm is not directly or indirectly managing investments.