HOUSE COMMITTEE ON APPROPRIATIONS

INTERIM CHARGE 2:

Review and evaluate the actuarial soundness of the Employees Retirement System and Teacher Retirement System pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit rating. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency. (Joint charge with the House Committee on Pensions, Investments & Financial Services)

The following constitute responses to a request for information regarding the above interim charge posted on August 5, 2020.

Glenn Hegar Texas Comptroller of Public Accounts

September 30, 2020

The Honorable Giovanni Capriglione, Chair
The Honorable Oscar Longoria, Vice Chair
Committee Members
House Committee on Appropriations
Building, Room E1.031
Austin, Texas 78701

The Honorable Jim Murphy, Chair
The Honorable Hubert Vo, Vice Chair
Committee Members
House Committee on Pensions, Investments and Capitol
Financial Services
Capitol Building, Room E2.164
Austin, Texas 78701

Via email: appropriations@house.texas.gov and jason.briggs@house.texas.gov

Members of the House Committee on Appropriations and House Committee on Pensions, Investments and Financial Services:

My office is providing information relating to "review and evaluate the actuarial soundness of the Employees Retirement System and TRS pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency." We are providing information in part on the effect the unfunded liabilities could have on the state's credit rating.

Over the past few years, the rating firms have updated their long-term obligation criteria to expand the weight of pension liabilities. While one of many criteria reviewed by the firms, the unfunded pension liabilities have become an increasing focus with the firms noting lower return targets and declines in investment performance will require higher actuarially determined contributions. Recent commentary from the firms has noted that declines in state revenues, in combination with the declines in investment performance, may require larger portions of the budget to maintain funding levels and address the growing pension liabilities.

The rating firms have noted the above average pension liabilities and weak funding practices as a risk to the state's credit rating. Moody's has noted that Texas has contributed below the Employee Retirement System's actuarially sound contribution since 2003 requiring rising amortization payments over time and that the failure to devise a sustainable plan to materially improve pension funding could lead to a downgrade. Standard and Poor's notes that the policy to fund to a fixed percent of payroll below actuarially determined levels leads to underfunding of the pension funds and the failure to contain long-term liability growth could pressure the credit quality without a credible plan and active management to stabilize or reduce such liabilities. Fitch notes that rising pension liabilities are likely to further increase carrying costs. The Kroll Bond Rating Agency has indicated that a significant decline in pension funding ratios could drive a rating change.

We appreciate the opportunity to provide you with this information. Please do not hesitate to contact my office if you have any questions.

Sincerely,

Glenn Hegar

Comptroller.Texas.Gov
P.O. Box 13528
Austin, Texas 78711-3528
512-463-4000
Toll Free: 1-800-531-5441, ext. 3-4000
Fax: 512-305-9711

EMPLOYEES RETIREMENT SYSTEM OF TEXAS

200 E. 18TH STREET, AUSTIN TEXAS 78701 | P.O. BOX 13207, AUSTIN, TEXAS 78711-3207 | (877) 275-4377 TOLL-FREE | WWW.ERS.TEXAS.GOV

September 23, 2020

Chair Capriglione and Members of the House Appropriations Committee:

Thank you for the opportunity to submit information related to the critical status of the Employees Retirement System of Texas (ERS) pension plans. ERS is entrusted with administering benefits to help you attract and retain a qualified workforce to carry out the important work of the state. These include both health insurance and an employee/employer-funded pension that – when combined with Social Security benefits and personal savings – supports employees in their retirement years. The role of state government is critical – both to the economy of Texas and to the health and safety of its residents. Providing the state workforce with competitive benefits is key to maintaining a strong workforce to achieve the mission of state government.

While the number of state employees has fluctuated through the decades, the current number of active employees in the ERS pension plan is near 141,000. This is approximately the same number of active state employees employed by the state in the early 1990's. As the Legislature has determined to have a lean workforce, it becomes more crucial to ensure that the workforce is efficient, skilled and experienced. When a lean workforce suffers from high turnover, the gaps in service become easily apparent. ERS conducted a member survey in late 2019 and found that 77% of ERS members cited the state's defined benefit retirement plan as a major reason they work for the state[1]. Ensuring the long-term viability of the pension plan is important to both you as the employer and plan sponsor, and to your workforce.

For the coming biennium, the comprehensive ERS health insurance program remains financially strong. Thanks to cost management initiatives and competitive contracting, ERS will not be requesting appropriations above its base funding level in order to maintain current benefits. **On the other hand, all three of the pension plans administered by ERS on behalf of the state are in funding distress and on a path to total fund depletion.**

Actuarial Valuation Results as of August 31, 2019*			
	ERS	**LECOSRF**	**JRS 2**
Actuarial Accrued Liability	$41.7 B	$1.5 B	$558 M
Actuarial Value of Assets	$28.1 B	$968 M	$468 M
Unfunded Accrued Liability	$13.6 B	$584 M	$90 M
Funded Ratio	67.3%	62.4%	83.8%
Funding Period (Years)	Never	Never	Never
Projected Depletion Date	**2061**	**2041**	**2063**

**Updated for 2020 Experience Study*

[1] https://ers.texas.gov/about-ers/reports-and-studies/reports-and-studies-on-ers-administered-benefit-programs/19097-2019-ret-ben-survey-results.pdf

"The current financial outlook for ERS is very poor. It is important to understand that the currently scheduled contributions are not expected to accumulate sufficient assets in order to pay all of the currently scheduled benefits when due. Based on current expectations and assumptions, ERS is projected to remain solvent until the year 2075. However, based on volatility in the financial markets, there is a strong possibility that ERS will become insolvent in a 30 to 40 year timeframe which is within the current generation of members. Contributions must materially increase in the next legislative session to secure the benefits for current members."

Gabriel Roeder Smith & Company, FY 2019 ERS Actuarial Valuation[2]

In early 2020, the ERS Board of Trustees performed the statutorily required experience study to evaluate both economic and demographic assumptions used for ERS annual valuation. During that experience study, the Board also reviewed the investment asset allocation for the ERS Pension to maximize returns while limiting the Trust's exposure to market downfalls and meeting liquidity needs for monthly annuity payments. Based on recommendations from the system's professional investment consultant and external actuary, in May 2020 the Board adopted new assumptions including reducing the investment rate of return to 7.0%. The Board felt it was important that the assumptions be current in order for ERS to provide the most up-to-date assumptions and funding needs during the upcoming legislative session.

Each year that the funding situation is not addressed depletes the fund sooner. The cost to the state when the fund depletes is at least four times the cost of pre-funding the benefits.

We look forward to working with you and the members of the 87th Legislative Session to return these critically important plans to actuarial soundness.

Please let me know if you need additional information to support your work and research.

Respectfully submitted,
Porter Wilson
Executive Director
Employees Retirement System of Texas

[2] https://ers.texas.gov/About-ERS/Reports-and-Studies/ERS-Actuarial-Valuation-Reports/2019-ERS-Pension-Valuation-Reports-December-2019.pdf

Interim Charge 2: Review and evaluate the actuarial soundness of the Employees Retirement System and Teacher Retirement System pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit rating. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency.

BACKGROUND

ERS was created effective September 1, 1947 by House Bill 168, 50th Texas Legislature, Regular Session. A constitutional amendment adopted by Texas voters in 1968 established ERS as a constitutional entity (Senate Joint Resolution 39, 60th Legislature, Regular Session). The provisions were consolidated in 1975 into current Article XVI, Section 67. Among the provisions in the Texas Constitution related to the ERS pension plan, there is a requirement that "Financing of benefits must be based on sound actuarial principles."

A six-member Board of Trustees governs the Employees Retirement System of Texas. The three appointed and three member-elected board members oversee investment of the retirement trust funds and the administration of state employee and retiree health benefits. The ERS Board also utilizes an Investment Advisory Committee (IAC) comprised of investment professionals created to consult and advise the ERS Board of Trustees on investments and investment related issues.

ERS manages three pre-funded retirement plans that provide retirement for the state's workforce, including general state agency employees, state law enforcement and custodial officers, and elected state officials, judges, and district attorneys. In addition, ERS administers a closed, pay-as-you-go plan for judges elected prior to 1985 referred to as JRS1. In a pay-as-you-go plan, the sponsor provides money that is equal to the cost of the benefits, rather than pre-funding the benefit cost by providing only a portion of the money and relying on investment returns to fund the majority of the cost.

Roughly 125,000 retirees and beneficiaries currently receive annuity payments from the three pre-funded Trust funds. The pension plans are designed to compensate state employees with steady income in their retirement. State employees, retirees and their beneficiaries live and work in 253 of the 254 Texas counties and help provide support to local economies across the state.

Since its establishment, the ERS retirement plan has been a cost-effective way for the state to provide reasonable retirement benefits to those who serve the State of Texas for their career. The retirement plans administered by ERS are:

Employees Retirement System (ERS) Retirement Trust Fund

- Employees and officers of every department, commission, board, agency, or institution of the State of Texas, except those who are covered by the Teacher Retirement System, JRS 1, or JRS 2
- Members of the elected class, including legislators, statewide elected officials, and district and criminal district attorneys

Law Enforcement and Custodial Officer Supplemental Retirement Fund (LECOSRF)

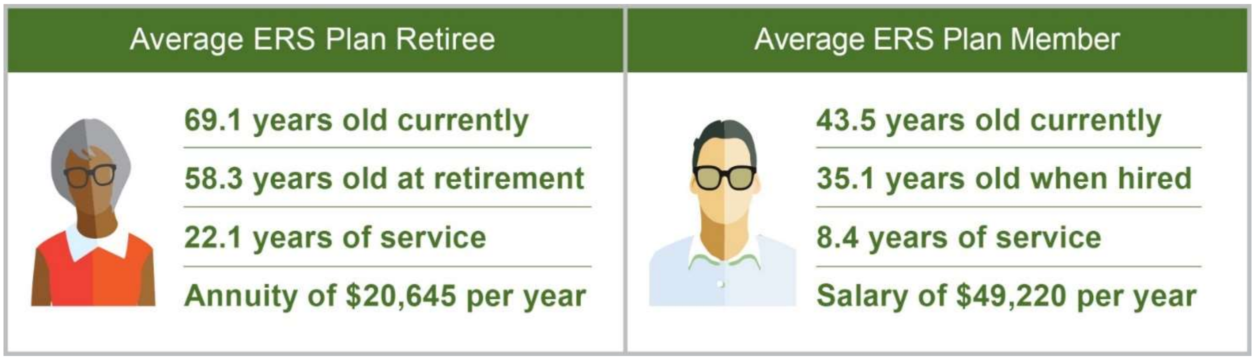
- Law enforcement officers who are commissioned by the Texas Department of Public Safety, the Texas Alcoholic Beverage Commission, or the Texas Parks and Wildlife Department, or the office of inspector general at the Texas Juvenile Justice Department, and who are recognized as commissioned officers by the Commission on Law Enforcement

- Custodial officers employed by the Texas Department of Criminal Justice (TDCJ), including the Board of Pardons and Paroles, and certified by TDCJ as employees who are required to have contact with state inmates

Judicial Retirement System of Texas Plan 1 (JRS 1) and Plan 2 (JRS 2)

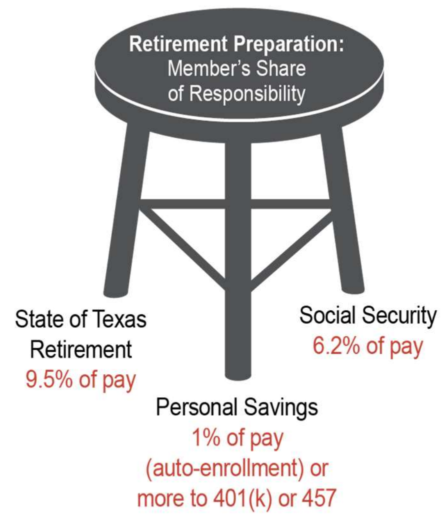
- Judges, justices, and commissioners of the Texas Supreme Court, the Court of Criminal Appeals, the Court of Appeals, and District Courts, and certain commissions to a court

As seen in the chart below, the average retired state employee earns $20,645 each year after serving the state for a little more than 22 years.



Member type	ERS	LECOSRF*	JRS 2
	State Employees Elected Officials District Attorneys LECOSRF members	Law Enforcement & Custodial Officer Supplement	Judges, justices & certain court commissioners (after 9/1/85)
Contributing Employees	141,865	36,296	573
Non-contributing Employees	125,935	22,207	187
Retirees/Beneficiaries	115,155	13,981	472

ERS manages a retirement trust on behalf of state employees and retirees who are beneficiaries of the defined benefit retirement plan. The money employees and the state contribute each month not only adds directly to the ERS Trust, but also generates interest revenue and investment income for the long-term funding of retirement benefits. Investment earnings make up roughly two-thirds of the ERS Trust's payouts to annuitants, while member and state contributions make up the remaining third.

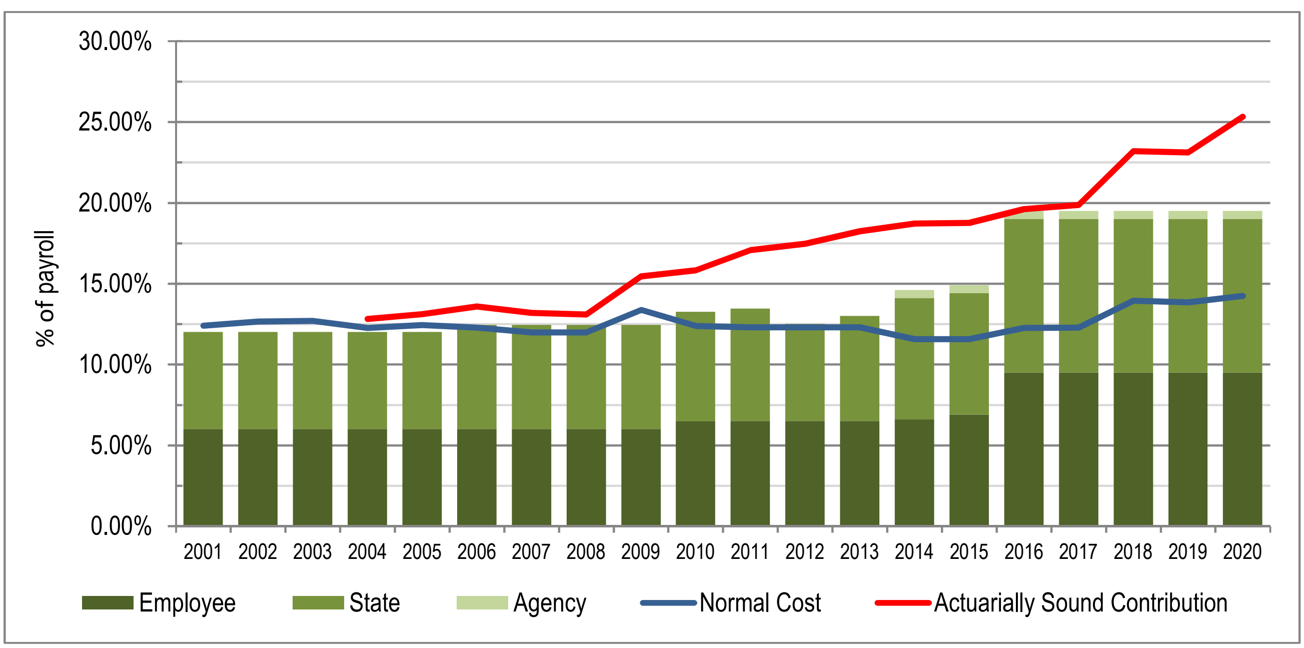


Both the member and the state contribute to the retirement system. State employees contribute 9.5% of their salary to the retirement system. State contributions are currently set at 9.5% of payroll with an additional 0.5% from state agencies. The total combined employee/employer contributions to the plan are 19.5% of payroll. In addition to the state pension contribution, state employees contribute 6.2% of their pay to Social Security and are automatically enrolled (unless declined) in the 401(k)/457 program at 1% of payroll.

Plan Funding

A sound pension fund is achieved when contributions plus investment earnings equal the benefits paid, plus operating expenses. While ERS administers the pension program and manages the investment of trust fund assets, the legislature sets the benefits and contributions levels for the plan. The ERS Board of Trustees has no ability to change benefit levels or alter contribution strategy – that authority lies solely with the Texas Legislature.

While the legislature has done an effective job of keeping the benefits affordable, contribution levels for the pension program have rarely met actuarially sound levels since the mid-1990s. As a result, the pension plan has a significant unfunded liability that has grown, even as the "normal" cost to provide the benefits remains reasonable at just under 15% of payroll[3].



[3] As of August 31, 2019 and updated for 2020 Experience Study

To achieve affordable retirement benefit levels, the legislature has adjusted the plan design for new employees twice over the last 10 years. In addition to plan design changes, the legislature has also increased the state and the employee contributions. Investment opportunities were expanded to maximize earning potential. While all these measures have helped, they are still insufficient to fully address the growing unfunded liability. Without further action, the ERS retirement program will continue on the path of fund depletion.

As required by Senate Bill 2224 (Huffman/Murphy), the ERS Board of Trustees adopted the ***ERS Pension Funding Priorities and Guidelines***[4] to help communicate to the legislature a path to returning the ERS plans to actuarial soundness and, further, to achieve 100% funding status[5]. The policy lays out a multi-level funding period goal to achieve funding according to the constitutionally required sound actuarial principles.

1. Fund plan normal cost
2. Avoid trust fund depletion,
3. Meet current statutory standard of a 31-year funding period, and
4. Match funding period to the average years of service at retirement once a 31-year funding period is achieved and closed.

With projected depletion dates for all three plans, the funding period goals are not being met and the state's liability continues to grow and the ultimate cost to the state rises significantly. In the FY 2019 Actuarial Valuation, the external actuaries determined the ERS unfunded liability is growing at a rate of $1 billion each biennium.

Depending on the final performance of the Trust Fund for FY 2020, the request to make the Actuarial Sound Contribution for the ERS plan is estimated to be approximately $340m GR/GRD and $475 AF per year. It is important to note that funding reform does not have to be an "all or nothing" strategy – small, phased-in contribution increases can be an effective plan to reform the contribution strategy for a pension plan.

CHALLENGES

Historic contribution shortage

The ERS pension plan reported the first unfunded liability in 2004. Since that time, the unfunded liability has continued to grow as contributions have not reacted to negative plan and investment experience. The legislature has addressed the growing liability by reducing benefits to state employees hired first after September 1, 2009 and then again for those hired after September 1, 2013. These changes have resulted in the different employee groups in the ERS and LECOS plans.

[4] https://ers.texas.gov/Shared-Content/Reports-and-Studies/Report_2018_FundingPolicy_2018_FINAL.pdf

[5] The ERS Board of Trustees adopted the initial version in May of 2018 and updated the document in August 2020 to include appropriate references to SB 2224

	Group 1	Group 2	Group 3
		Created by 81st Legislature	Created by 83rd Legislature
	Employees hired before 9/1/2009	Employees hired 9/1/2009 – 8/31/2013	Employees hired on/after 9/1/2013
Minimum retirement Age[1]	60 with 5 years service credit (55 with 10 years LECO)	65 with 10 years service credit or Rule of 80 (55 with 10 years LECO)	
Annuity reduction when retiring before certain age	No reduction	5% per year, 25% cap Age 60 – Regular Class Age 55 – LECO[2]	5% per year, no cap Age 62 – Regular Class Age 57 – LECO[2]
Highest average salary based on:	36 months	48 months	60 months
Multiplier	2.3% - Regular Class 2.8% - LECO[2]	2.3% - Regular Class 2.8% - LECO[2]	2.3% - Regular Class 2.8% - LECO[2]
Unused leave can count toward eligibility?	Yes	No	No
Unused leave can help increase annuity?	Yes	Yes	Yes - if not taken as a lump sum
Membership Count [3]	48,874 (34%)	20,484 (15%)	72,889 (51%)

As of the FY 2019 Actuarial Valuation, 65% of current state employees are members of the reduced benefit groups, Group 2 and Group 3. The normal cost for Groups 2 and 3 is lower than the normal cost for Group 1 which demonstrates that previous benefit reductions have helped minimize the rate of growth of the unfunded liability. Additionally, contributions for both the state and employees increased in FY 2016.

Contribution Strategy

The current ERS pension contribution rates were established during the 84th Legislative Session and prior to that were unchanged for many years. Well-funded and well-designed pension plans have a contribution funding strategy that responds quickly to negative investment performance or actuarial experience.

Many successful plans across the nation, and here in Texas, establish an adequate contribution rate each year that the plan sponsors/employers are required to contribute so that any negative experience or unfunded liabilities are quickly addressed with small changes in the contribution rate. The ERS pension plans are not funded at the statutorily determined sound contribution rate[6]. When funding is not based on the actuarial need of the plan, it can lead to the development of an unfunded liability, which continues to grow until addressed. At that point, it often requires a large contribution increase, which is the case for the state's plan. If contributions were adjusted more frequently, the funding increases would be incremental rather than drastic.

Investments and Negative Cash Flow Pressure

The ERS Board of Trustees is responsible for adopting an investment asset allocation for the ERS Pension Trust Fund. This allocation is reviewed regularly as part of the statutorily requirement to perform an actuarial experience study at least every 4 years[7]. Additionally, the asset allocation is a closely monitored and discussed item at ERS Board of Trustees meetings.

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[6] Texas Government Code §811.006 and §840.106

[7] The ERS Board of Trustees conducted an Experience Study in FY 2020 with final adoption of updated assumptions at the May 2020 meeting. https://ers.texas.gov/About-ERS/Reports-and-Studies/ERS-Actuarial-Valuation-Reports/Pension-Experience-Study-Report-May2020.pdf

When setting the asset allocation, the overarching goals are:

- Manage assets to ensure payment of monthly annuities earned by members and beneficiaries of the retirement plans;
- Seek to maximize investment return while maintaining acceptable levels of risk;
- Reduce risk through diversification;
- Efficiently manage investment program costs; and
- Manage fund assets for the exclusive benefit of plan members

The ERS Board strives to maximize returns while limiting the Trust's exposure to market downfalls and meeting liquidity needs for monthly annuity payments. In FY 2019, the Trust paid out $2.753 billion each year in annuity payments, and received $1.565 billion in contributions[8]. This negative cash flow affects how the Trust can invest assets and puts pressure on the Trust to maintain a higher percentage of liquid assets that can be readily used to pay benefits.

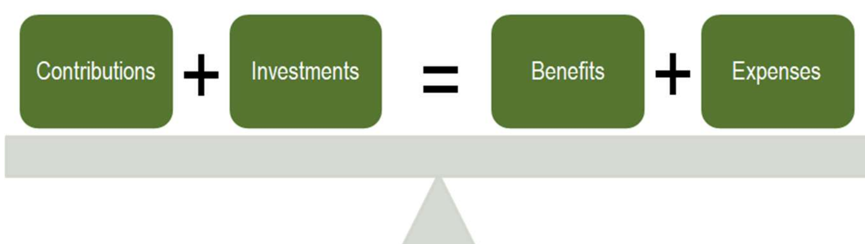
Potential State Credit Rating Impact

Bond rating agencies have taken note of states' pension debt in their rating determination process. As recently stated by Moody's related to Texas' 2020 TRAN issue, "The outlook for the state of Texas is stable. The state's long-term economic fundamentals and its reserve position are strong but reaching structurally balanced budget solutions to the coronavirus-induced revenue downturn will be challenging amid growing demand for education, transportation and pension funding."

While the other positive factors have allowed Texas to maintain its high bond rating, concerns around pension liability is a factor that credit rating agency take note of and, further, expect states to show progress or a plan for addressing unfunded pension liabilities.

SOLUTIONS

A sound pension plan is a balanced pension plan. The equation below shows how a pre-funded pension plan is envisioned to work -- contributions + investment earnings should be equal to (or greater than) the cost of benefits promised + plan administrative expenses.



The path to balancing a plan that is to adjust factors on one side or the other of the equation – increase contributions on the left side of the equation and/or decrease benefits on the right side of the equation. Of all the parts of this equation, contributions and benefits are the two tools that can have a meaningful impact on the rebalancing of the ERS pension plans. Relying on a solution through investments requires dependence on much higher risk investments that may not align with the fiduciary standards of the ERS Board of Trustees and higher returns are not guaranteed. Additionally, the ERS plan administration costs are very low relative to the total cost of the plan and the unfunded liability. Therefore, altering contributions and/or benefits are the factors that have the most significant impact on reforming the struggling ERS pension plans.

[8] https://ers.texas.gov/About-ERS/Reports-and-Studies/Reports-on-Overall-ERS-Operations-and-Financial-Management/2019-CAFR.pdf

Contribution Increase
In preparation for the 87th Legislative Session, ERS will submit an FY 2022-2023 Legislative Appropriations Request for the statutorily determined, Actuarially Sound Contribution (ASC) rate. Depending on the final performance of the Trust Fund for FY 2020, the ASC request for the ERS plan is estimated to be approximately $340m GR/GRD and $475 AF per year. LECOS and JRS2 will have smaller appropriations requests. Again, funding reform does not have to be an "all or nothing" strategy – small, phased-in contribution increases can be an effective plan to reform the contribution strategy for a pension plan.

As other plans across the nation have faced funding challenges for their pension plans, various tools have been used to find alternative sources of revenue to support funding reform. The ERS 2012 report, ***Sustainability of the State of Texas Retirement Program***[9] discussed additional revenue options including general obligation bonds. During this time with historically low interest rates, it may be valuable for the state to research the possibility of utilizing general obligation bonds to address the ERS unfunded pension liabilities. As with all solutions, there are positive and negative implications, statewide debt considerations and basic questions to be answered, however, current economic conditions may warrant further research.

Benefit Changes
Struggling pension plans often look to benefit changes to reduce a plan's unfunded liability. The Texas Legislature took that approach with benefit reductions to then-future employees creating Group 2 in 2009 and Group 3 in 2015. Members in these groups cannot retire until age 60/62 without taking a reduction to their annuity, final average salary provisions have been extended to 48/60 months and neither group permits the member to use unused leave to meet retirement eligibility. With 65% of current, active members in those two groups and 50% in Group 3 alone, the new benefit structure has reduced costs.

Unlike many other plans who can achieve significant savings by reducing or eliminating cost of living adjustments, the state retirement plan was never designed to provide a guaranteed Cost of Living Adjustments (COLA) or automatic bonus check.

The legislature's hard work on past benefit reductions have done the intended purpose of lowering the costs associated with the actual benefit. With the heavy lifting done, there are fewer benefit reduction options that could make a significant actuarial impact on the plan's unfunded liability. The remaining benefit reductions, such as a reduction in the multiplier, would have to be applied to current employees. Reductions of this type could cause a rush to retirement, and negatively impact the state's ability to recruit and retain the workforce it needs.

It is important to note that the current unfunded liability represents benefits that have been earned and cannot be "erased" by changing to a different type of retirement plan structure. In fact, without contributions from members into the existing plan, the current unfunded liability would become larger and more expensive for the state to address. As the funding stands today, a large portion of the current contributions are going toward payment for the unfunded liability – any loss of current contributions for benefits from previously earned service will increase the cost to the state to pay for those required, ongoing costs associated with those earned benefits.

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[9] https://ers.texas.gov/About-ERS/Reports-and-Studies/Reports-and-Studies-on-ERS-administered-Benefit-Programs/2012_IBS-Retirement-Report.pdf

TRS
TEACHER RETIREMENT SYSTEM OF TEXAS

Brian K. Guthrie
Executive Director

800.223.8778
www.trs.texas.gov

1000 Red River Street
Austin, Texas 78701-2698

August 2020

Texas House Committee on Appropriations

Request for Information on Interim Charge #2: Review and evaluate the actuarial soundness of the Employees Retirement System and TRS pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency. (Joint Charge with the House Committee on Pensions, Investments and Financial Services)

Executive Summary

At more than $155 billion, the TRS pension trust fund is the 6th largest public pension fund in the US and one of the 25 largest funds in the world.[1] Our long-term investment objective is to earn a return of 7.25%, within strictly outlined risk parameters. As a result of increased contributions under 86R Senate Bill 12, the TRS pension trust fund was determined to be actuarially sound with a 29-year amortization period in its 2019 actuarial valuation.[2]

Additionally, the 86th Regular Legislative Session passed Senate Bill 322, requiring TRS and certain other public retirement systems to select an independent firm to evaluate the appropriateness, adequacy, and effectiveness of the retirement system's investment practices and performance. An independent evaluation concluded that TRS is performing in a manner consistent with best-in-class peers.

Review and evaluate the actuarial soundness of the TRS pension fund. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the fund.

The 86th Legislature adopted Senate Bill 12, which statutorily requires increases in contribution rates to the pension trust fund for the state, employers, and members in a phase-in schedule that will end in Fiscal Year 2025. The state's base rate of 6.80% in Fiscal Year 2019 increased to 7.50% in Fiscal Year 2020 and will phase-in to 8.25% by Fiscal Year 2024. The estimated incremental increase to the state's pension fund contributions for the 2022-23 fiscal biennium is $540 million over the

[1] Fund balance as of June 30, 2020. Fund ranking by Willis Towers Watson.
[2] TX Gov't Code Sec. 821.006 limits actions that would cause the amortization period of the pension trust fund's unfunded liability to exceed 31 years. A funding period of 30 years or less is considered to be actuarially sound.

2020-21 fiscal biennium. In addition, all public education employers—regardless of whether the public education employer participates in Social Security—will pay a contribution that will gradually increase from 1.50% in Fiscal Year 2020 to 2.00% in Fiscal Year 2025. Prior to Senate Bill 12, only public education entities that did not contribute to Social Security* were required to pay the 1.50% contribution. The member contribution rate will increase from the current 7.70% to 8.00% in Fiscal Year 2022 and ultimately 8.25% in Fiscal Year 2024.

	Previous	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
STATE	6.80%	7.50%	7.50%	7.75%	8.00%	8.25%	8.25%
MEMBERS	7.70%	7.70%	7.70%	8.00%	8.00%	8.25%	8.25%
PUBLIC ED EMPLOYER	1.50%*	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%

According to the 2019 actuarial valuation, based on the scheduled contribution rates and current assumptions, it is estimated that the unfunded actuarial accrued liability ("UAAL") will increase for approximately a decade before beginning to decline. If assumptions are met and payroll grows as expected (3.00% per year), the contributions provided by the increased contribution rate pattern are sufficient to amortize the current UAAL of the system over a period of 29 years.[3] The next actuarial valuation will take place on August 31, 2020.

TRS Trust Fund Valuation	8/31/2018	8/31/2019
Unfunded Actuarial Accrued Liability (UAAL)	$46.2 Billion	$49.5 Billion
Funding Period	87 Years	29 Years
Investment Return Assumption	7.25%	7.25%

Examine the effect the unfunded liabilities could have on the state's credit.

The Texas Comptroller of Public Accounts states that "The enormous costs and liabilities of large public pension systems could have serious financial effects on governments. If left unchecked over time, pension costs may affect their credit ratings, which in turn could drive up their borrowing costs and deepen any financial difficulties."[4]

[3] https://www.trs.texas.gov/TRS%20Documents/actuarial_valuation_pension_fund_2019.pdf
[4] https://comptroller.texas.gov/economy/fiscal-notes/2019/feb/liabilities.php

The legislature addressed this concern through its gradual increase in contributions to the TRS pension trust fund in 86R Senate Bill 12. However, a reduction in the state contribution rate will result in a proportionate reduction in the public education employer and active employee contribution rates. A reduction in planned contribution rates will negatively impact the fund's amortization period and increase the unfunded actuarial accrued liability.

Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency.

Under Article XVI, Section 67 of the Texas Constitution, the TRS Board of Trustees ("Board") is responsible for the administration of the system and the prudent investment of its funds.

To comply with fiduciary standards, monies held in trust must be used exclusively for the benefit of TRS members. The Board is composed of nine members appointed by the Governor in accordance with statutory requirements.[5] The Board of Trustees act as fiduciaries of the pension trust fund's assets. Currently, six members have backgrounds in finance and/or investments.

- Three trustees are direct appointments of the Governor and must have demonstrated financial expertise or broad investment experience.
- Two trustees are appointed by the Governor from a list prepared by the State Board of Education and must have demonstrated financial expertise or broad investment experience.
- Two trustees are appointed by the Governor from three active member candidates who have been nominated by employees of public school districts, charter schools, or regional education service centers.
- One trustee is appointed by the Governor from the three at-large member candidates nominated by employees of higher education institutions; by employees of public school districts, charter schools, or regional education service centers; and by TRS retirees.
- One trustee is appointed by the Governor from three TRS retiree candidates who are nominated by TRS retirees.

The TRS Board of Trustees directs the investments of the fund through the establishment of the asset allocation (*see Appendix, Exhibit 1*) and the Investment Policy Statement (IPS).[6] The IPS provides a formal plan for investing pension trust assets. The Board reviews staff recommendations and updates the asset allocation at least once every five years, in an effort to achieve TRS' expected rate of return of 7.25%. An independent review by Aon Hewitt Investment Consulting Inc. ("Aon"),

[5] TX Gov't Code Sec. 825.002.
[6] https://www.trs.texas.gov/Pages/investment_strategy.aspx

as required by 86R Senate Bill 322, found that "TRS has a leading-edge practice for developing asset allocation, assets are well diversified, and risk is being measured and managed appropriately."[7]

Under state law, the Board is permitted to delegate investment authority with respect to the pension trust assets to the executive director or the staff of TRS. The IPS defines the roles and responsibilities of the Board and the Investment Management Division ("IMD") and the bounds of the delegated authority. Other critical aspects of the IPS include:

- Long-term asset allocation and benchmarks;
- Rebalancing ranges and thresholds;
- Risk management practices and limits; and
- Monitoring and reporting requirements.

The independent evaluation by Aon also found that TRS' IPS is "comprehensive and follows best practice, it contains appropriate measurable outcomes, and it is being followed."

Notwithstanding the delegation of certain investment authority, the Board monitors the actions of staff to ensure compliance with its policies. To aid its prudent oversight and ensure the investment program is in compliance with all policies, the TRS Board established an Audit, Compliance and Ethics Committee, Investment Management Committee, Policy Committee, and a Compensation Committee. The Board meets approximately five times each year and closely monitors investment opportunities through a monthly Transparency Report, which details pending and prospective investment opportunities. The IMD also reports quarterly at Board meetings on pension trust fund positioning and performance reviews, gives updates on long-term objectives and short-term goals, and provides a focused review of an asset class or IMD portfolio group.

The TRS Compliance division oversees the IMD's compliance with the Board adopted investments-related policies, which includes the IPS, Securities Lending Policy, Proxy Voting Policy, and the TRS Personal Trading Policy (which is not a Board adopted policy). In doing so, TRS Compliance:

- Monitors TRS' private investments and trading activities in public markets, exchange-traded and over-the-counter ("OTC") derivatives, and other instruments, to ensure the IMD's compliance with applicable regulations and laws.
- Provides insights and comments during operational due diligence of investment opportunities presented to the Internal Investment Committee ("IIC") and provided in the monthly Transparency Report. The IIC is composed of ten senior staff members of the IMD as well as the executive director. The IIC reviews, considers, and authorizes proposed investments and external manager engagements as required by the IPS.

[7] https://www.trs.texas.gov/TRS%20Documents/board_book_april2020.pdf

- Manages and oversees information barriers related to potential material non-public information ("MNPI") possessed by TRS and provides guidance and training to IMD related to securities laws' prohibitions on insider trading and other matters related to MNPI.
- Implements and oversees employee compliance with the TRS Personal Trading Policy, including administering and maintaining TRS' trade pre-clearance and surveillance software to aid in the prevention and detection of improper trading.
- Reviews nine daily reports with approximately 500 testing points provided by TRS' custodian that include warnings and alerts covering rules and thresholds established by the above-mentioned policies for its internal and external investment activities.

TRS Compliance performs quarterly testing of the IPS to confirm that IMD staff complies with the adopted Board policies. Quarterly testing results are reported to the Board and any material policy violations are provided to the Board in the Transparency Report.

TRS is committed to transparency. Aon's evaluation found TRS to be "leading-edge in terms of its transparency, exceeding that of many public retirement systems." TRS posts the IPS on our public website. Our website also has dedicated pages outlining investment teams, strategies, risk management, performance, and describes how investment decisions are made. TRS Board meetings are live-streamed online and archived for public viewing. TRS discloses fees and expenses charged by external managers in its Comprehensive Annual Financial Report. IMD staff conduct ongoing policy reviews with the goal of driving the investment industry towards increased transparency and reduced investment management fees. The investment management function has undergone more than 100 audits and independent reviews over the past six years with no major findings. The following table highlights some of our reports, audits, and reviews:

Statute	Report Type	Frequency
802.101(c)	Actuarial valuation	Annually
802.103(a)	Comprehensive Annual Financial Report	Annually
802.108	Report of investment returns and assumptions	Annually
802.109	Independent review to evaluate the appropriateness, adequacy, and effectiveness of the retirement system's investment practices	Once every three years
825.108(a)	Fiscal transactions including cash and securities amounts, investment rate of return	Annually

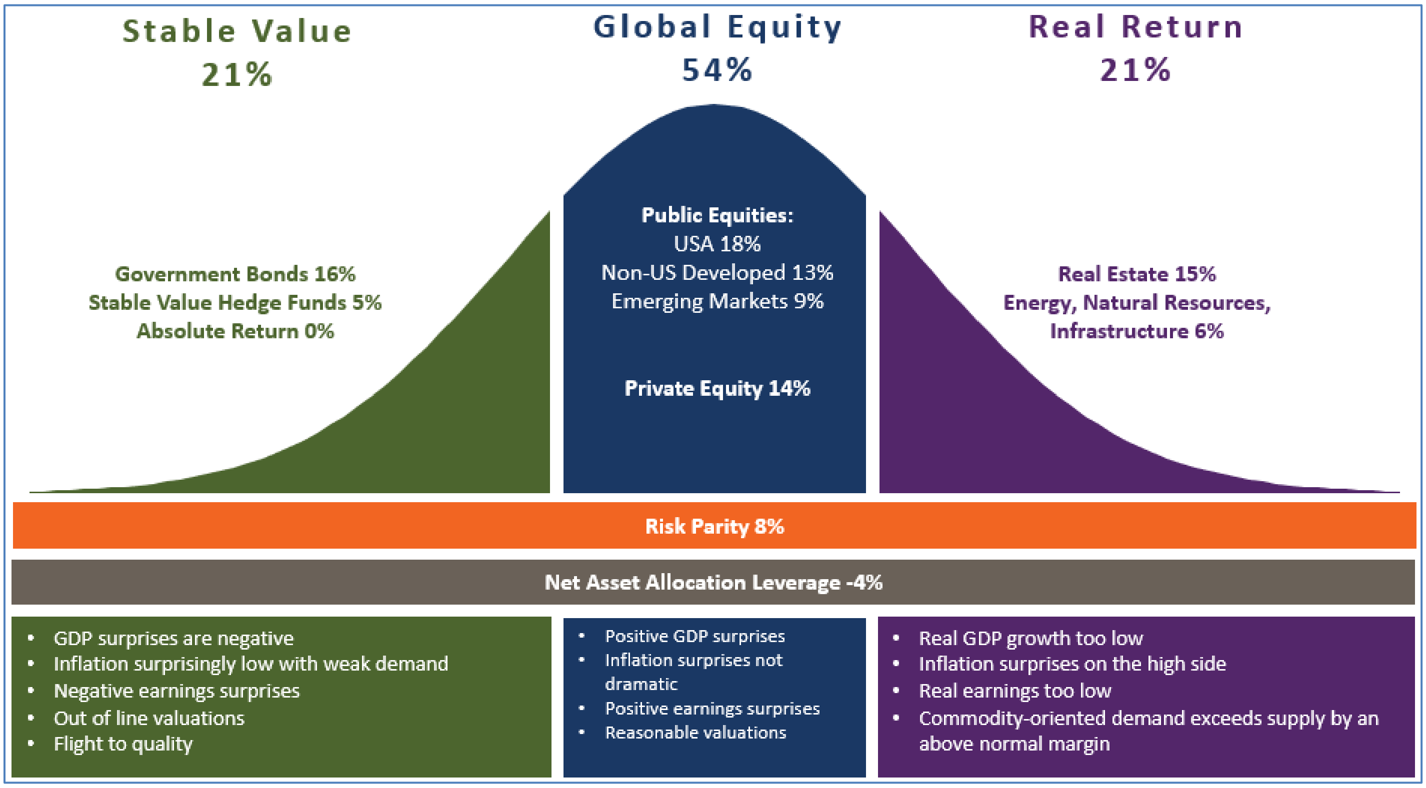
825.108(b)	Balance sheet as of Aug. 31 prior Fiscal Year; actuarial valuation assets & liabilities	Annually
825.108(e)	Accounting for all funds received and disbursed	Annually
825.108(f)	Report on use of appropriated funds	Biennially
825.111	Legislative Audit Committee engages an independent management audit	As frequently determined by the Committee
825.206(f)	Actuarial Audit	In conjunction with actuarial experience study or at least once every five years
825.512	Legislative Audit Committee selects independent firm to evaluation investment practices and performance reports	Biennially (satisfied by 802.109)
825.512(e)	Investment performance report including all commissions and fees paid	Annually

Texas State Auditor's Office	**Frequency**
Audit of Teacher Retirement System's Fiscal Year Financial Statements	Annually
Audit of Incentive Compensation at the Permanent School Fund, General Land Office, Teacher Retirement System, and Employees Retirement System	Annually

TRS will continue to conscientiously and prudently manage the pension trust fund for the long-term financial interests of the members we serve.

Appendix

Exhibit 1: Strategic Asset Allocation



AFSCME Texas Retirees

1812 Centre Creek Drive, Suite 130 • Austin, Texas 78754-5132
1-800-221-9181 • 512-477-9181 • office@afscmetexasretirees.org
www.afscmetexasretirees.org • AFSCME Texas Retirees Chapter 12

August 26, 2020

My name is Luther Elmore and I am President of AFSCME, Texas State Retirees. I am submitting this statement on behalf of myself and the membership of AFSCME Texas Retirees.

The American Federation of State, County, and Municipal Employees, Texas State Retirees, is an organization of over 8,000 retired former employees of the State of Texas. We have members from all over the state who worked for many different state agencies, performing many different jobs for the citizens of this state.

During our years as employees of the State of Texas, most of us paid 6.5% of our salaries into retirement funds held by the Employees Retirement System. Now that we are retired, we receive a monthly annuity for our contributions to the fund. There are about 115,000 state retirees and their survivors that receive benefits. Currently, ERS has approximately $29 billion in funds that it invests to solidify those funds. The average monthly annuity received by our retirees is about $1,700 a month.

As late as the year 2001 the funds were actuarially sound. That is no longer the case. It is estimated that ERS is $12 billion short of meeting its future obligations, is only 70% funded, and faces total depletion by 2075. To partially address this issue, in recent years the contribution rate paid by state employees has been steadily rising. In 2014 the rate went from 6.5% to 6.6%; in 2015 to 6.9%; and in 2016 to 9.5% for newly hired state employees. In addition, state retirees have not had a cost of living adjustment since 2001. This means that they have seen a reduction of the purchasing power of their annuity of approximately 30% over the last 20 years. Many retirees, especially those on the lower end of the income scale, are finding it increasing difficult to make ends meet.

During the last Legislative Session in 2019, the Legislature addressed the dire situation faced by teachers in Texas with the promise that they would address state retirees in 2021. Please follow through with that commitment made two years ago and fund the plan. Do not turn your back on the individuals who throughout their working life worked for you and the other citizens of the great state of Texas.

Texas state retirees need your support and financial commitment as you honor their service to the state.

I implore you to fund the plan and do what is right for Texas state retirees so they can live out their remaining years with a dignified, secure retirement.

Thank you.

Luther Elmore
President, AFSCME Texas State Retirees

Texas AFT
A Union of Professionals
www.texasaft.org

3000 S. IH-35
Suite 175
Austin, TX 78704

(512) 448-0130
(800) 222-3827
f: (512) 448-0678

September 30, 2020

To the Members of the Texas House Appropriations Committee:

Texas AFT is writing with regards to Interim Charge 2:

Review and evaluate the actuarial soundness of the Employees Retirement System and TRS pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency.

Our public pension systems have ensured retirees in Texas can continue paying their rent, buying groceries, and going to the doctor during one of the largest public health crises in our country's history. They help drive our economy, as most of money paid out of these pension annuities stays in Texas, boosting local businesses and contributing to the overall health of our workers.

In the past 84 years, the membership and responsibilities of the Texas Teacher Retirement System (TRS) has grown to cover 1.6 million active and retired public school employees, including those in higher education. TRS is the largest public pension system in Texas, and one of the largest in the country, with more than $158 billion in assets. TRS is a stabilizing force for retirees and for the state's economy. As a defined benefit system, it has ensured public school employees can plan for their future and meet their basic needs during retirement. TRS being a defined benefit system also has meant its participants are better able to weather economic storms, such as the one we are currently in with COVID-19, as compared to Texans relying on 401(k)-type plans. This is important at a time when many communities have been hit hard by shutdowns, businesses are struggling to stay open, and thousands of Texans are facing financial hardship.

While the TRS pension fund is sustained primarily by TRS member contributions during their working careers, state contributions, and investment revenues, the state's investment is the fund's most stable source of revenue. With a fluctuating workforce, there is only so much local school districts and employees can put into the system before it becomes financially burdensome. Any reduction in the state contribution rate will have a domino effect on the employer and employee contribution rates that could impact the fund's health and will increase the unfunded actuarial accrued liability, leading to a longer amortization period. We cannot allow a difficult budget session this year risk undoing the positive gains made during the last legislative session.

TRS members receive around $2,000 per month, but most teachers in Texas do not receive Social Security; their pension has to pay for everything. As they age, many of our retirees will find their buying power depleted because of inflation, and too many already live close to the poverty line. Rent, medications, insurance, and food costs all continue to inch upwards, to say nothing of unexpected expenses. The "13th check" retirees received last year was a welcome one-time payment, but retirees need lasting relief.

By law, neither of our two state pension systems can provide retirees a Cost of Living Adjustment (COLA) unless they are in actuarially sound condition — defined by statute as having an amortization period under 31 years. TRS only just reached this milestone with the investments made by the Legislature last session. We must begin planning now for how to implement an indexed COLA for our educators.

TRS has received high praise for its investment strategies and fund management by outside evaluators, but it still faces challenges. TRS has a top-rated investment team that has done tremendous work to bring in returns. Markets can be unpredictable, however, and TRS' reliance on alternative investments has grown exponentially since 2008. These alternative investments, including hedge funds and private equity funds, make higher gains on investments possible but they also bring greater market risk and higher fees. These investments come with more barriers to transparency so that it may be harder to assess what TRS is getting for their money. The true value of private equity assets often cannot be calculated until after they have been liquidated which may not happen for years or decades.

The Legislature can help safeguard the fund's health by sure TRS has the resources it needs to implement the changes recommended by the Sunset Commission's staff report. These changes also will help to improve transparency in the fund's operations and its investments.

The Sunset report found:

- TRS could reduce risks in its investment accounting by using a fully independent or automated system to better identify accounting inconsistencies.
- The agency lacks a formalized process for reviewing internal investments.
- TRS should provide stakeholder-friendly information about alternative investments in its Comprehensive Annual Financial Report.

The need for legislative support is compounded by recent changes to our statewide pension systems' expected rates of return. TRS lowered its expected rate of return from 8% to 7.25% in 2018. Recently, the investment team from ERS downgraded their expected rate of return to from 7.5% to 7%. Previously, it had lowered its rate from 8% to 7.5%. This move is similar to those made by many other pension investment teams around the country in recent years. The once standard 8% expected rate of return for pension systems in the United States no longer reflects our economic reality, at least for the immediate future. TRS' average return on investments over the past five years has been 6.7%, with 8% having been the goal for four of those years according to Public Plan Data. Also, over the past five years, TRS has continued to accumulate unfunded liabilities. The 2019 actuarial valuation estimates these will continue to increase for the next 10 years before going down. However, if assumptions are met and payroll grows as expected (3% per year), then the contributions provided at the increased contribution rate pattern outlined in SB12 are sufficient to amortize the current unfunded actuarial accrued liability of the system in under 31 years. This is good news for the fund, for Texas, and for the state's retired teachers as it means costs for managing the fund will decrease over time, and TRS will be in an even better position to serve its members.

Lawmakers must hold the line on the progress they made to secure TRS last session and keep the pension system healthy by maintaining the funding in SB12. We know the COVID-19 pandemic has altered every aspect of our state's economy and day-to-day operations. The Legislature maintaining its commitment to our public pensions is necessary for the long-term economic health of the state and, more importantly, the well-being of its people.

Thank you for considering our comments as part of your future recommendations and planning.

Sincerely,

Dena Donaldson
Government Relations Specialist & Policy Analyst | Texas AFT
T: 512-448-0130 | M: 623-210-5054 | E: ddonaldson@texasaft.org
Texas AFT, AFL-CIO
3000 South IH-35, Suite 175 | Austin, TX 78704 | F: 512-448-0678
www.texasaft.org | www.fb.com/TexasAFT | www.twitter.com/TexasAFT

Department of Public Safety Officers Association

August 28, 2020

Chairman Capriglione and Chairman Murphy

RE: Joint Interim Charge on Actuarial Soundness of the Employees Retirement System

Dear Chairmen,

In response to your formal request for information regarding the joint interim charge to review and evaluate the actuarial soundness of the Employees Retirement System (ERS), the Department of Public Safety Officers Association (DPSOA) would like to emphasize our strong support for funding of the ERS and Law Enforcement and Custodial Officers Supplemental (LECOS) retirement system at actuarily sound levels and preservation of our defined benefit retirement plan. We also ask for your consideration of Comptroller Hegar's original Legacy Fund proposal to create a permanent endowment that would generate new revenue to be applied towards the state's pension obligations.

Maintaining a healthy retirement system is essential to retain and attract the best employees, and DPSOA stands ready to help you achieve this goal.

Thank you,

Richard Jankovsky, President
Texas Department of Public Safety Officers Association (DPSOA)

Texas Classroom Teachers Association
PO Box 1489 | Austin, Texas 78767
888-879-8282 | 512-477-9415 | Fax: 512-469-9527
tcta.org

Response to House Public Education Committee Request for Information
Regarding Interim Charge 2 (TRS Pension Fund)

Submission from:
Ann Fickel
Associate Executive Director
On behalf of the Texas Classroom Teachers Association
P. O. Box 1489
Austin, TX 78767
afickel@tcta.org
512-477-9415

The Texas Classroom Teachers Association appreciates this opportunity to provide input on the committee's interim charge relating to the actuarial soundness of the Teacher Retirement System pension fund.

Interim Charge 2: Review and evaluate the actuarial soundness of the Employees Retirement System and TRS pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency.

The Texas Legislature has made major investments in the Teacher Retirement System pension fund over the last few years. In 2019 lawmakers approved SB 12, a plan to gradually increase contributions from the state, school districts, and employees to improve the actuarial soundness of the fund. This plan has been successful to date, with the funding period improving from 87 years to 29 years between 2018 and 2019. (Note that information on the fund's actuarial report for 2020 will not be available until later this fall.) Still, taking into account that the state does not contribute to Social Security for school employees, Texas has among the very lowest contributions to retirement for its school employees among all the states. **TCTA strongly recommends that the legislature not only continue to honor its commitment, but consider further increasing contributions, to ensure the strength and stability of the pension fund and a secure retirement for school employees.**

It is difficult for any fund to weather the market volatility that has been experienced over the past 20 years, but TRS has provided sound management of the fund's investments, often outperforming its peers. We appreciate the agency's plan to move more investments to in-house staff to reduce reliance on outside management and lower the accompanying fees. However, we have concerns about other expenditures related to the investment management division, particularly with regard to the well-publicized controversy over the division's office space.

In general, although we see room for improvement (much of which has been included in the recommendations of the Sunset Advisory Commission staff report), we believe TRS has provided good management for the pension and health insurance plans. **However, some guidance for improved practices may be warranted, particularly with regard to agency expenditures and to the expansion of transparency measures.**

30 September, 2020

To the Members of the Committee:

The Texas Pension Coalition is writing with regards to Interim Charges 2 and 7 for the Texas House Appropriation Committee.

Interim Charge 2

As stated in Interim Charge 2, the committee is charged with the following task:

> Review and evaluate the actuarial soundness of the Employees Retirement System and TRS pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency.

It is the shared belief among the members of the coalition that your committee and the entire legislature has a constitutional obligation to do whatever is necessary to maintain the actuarial health of our two statewide public pension systems.

The Employees Retirement System is in dire need of funding. Based on changes made following the system's most recent experience study, ERS now has a funding ratio below 70 percent. The complete unfunded liability for ERS now stands at $13.6 billion. Further, its depletion date––the point at which ERS Trust can no longer pay annuities and the system reverts to an astronomically expensive PAYGO model––has moved up from 2075 to 2061. While this still seems decades away, every year in which legislators don't tackle the depletion date adds hundreds of millions, and eventually billions, more in costs.

Make no mistake, however, in assuming this is solely because of COVID-19. For years, ERS has been underfunded by the legislature. In the past fifteen years, total contributions have only matched the actuarially sound contribution once. Currently, the actuarial sound contribution rate is just over 25%. The contributions by the state, employing agencies, and workers, however, only total 19.5%, and that gap consistently prevents the system from performing as well as it could.

This gap between what our systems need and what the state puts in is having considerable impact on the well-being of our retirees. By law, neither of our two state pension systems can provide retirees a Cost of Living Adjustment (COLA) unless they are in actuarially sound condition––defined by statute as having an amortization period under 31 years. Because the state has consistently underfunded both systems, anything resembling a true COLA has felt like a pipe dream for most retired public employees.

Pensions are based on a worker's final salary range, and because most public employees earn less than what they would in the private sector, their pensions are also going to ultimately be modest, even if they put in a full career in public service. As a result, the average ERS pension is a bit over $1,700 a month. TRS recipients receive a bit more per month––around $2,000––but the overwhelming majority of teachers in Texas do not receive Social Security: their pension has to do everything. When coupled with inflation, a pension that makes ends meet at the beginning of someone's retirement can quickly fall short unless periodic adjustments are made to account for the rising cost of living in the state. Rent, medications, insurance, and food costs all continue to inch upwards, to say nothing of unexpected expenses. Without legislative action, retired public employees are left waiting every few years for a sporadic "13th check": a welcome bit of relief, but nothing resembling the sustained change people really need.

The need for a legislative solution is compounded by recent changes to our statewide pension systems' expected rate of return. A rate of return is a studied estimation of a system's long-term growth. While the year-to-year growth of a pension system may be volatile––up greatly some years, stagnant in other years––a smoothed long-term estimate, particularly the 30-year outlook, gives us the best sense of the overall needs and health of the system.

Recently, the investment team from ERS downgraded their expected rate of return to from 7.5% to 7%. It had previously lowered its rate from 8% to 7.5%. This move is highly similar to those made by many other pension investment teams over the past couple years. This includes TRS, which lowered its expected rate of return from 8% to 7.25% in 2018.

While the 8% expected rate of return was a standard across pension systems in the United States, it no longer reflects our current economic reality, one in which several years of spotty growth have now been severely compounded by the ongoing pandemic. Keep in mind: pensions are still faring better than individualized investments, and will weather this storm better than any 401(k)-type plan ever can. However, the 8% standard is no longer a reality for the immediate future, at least.

The prudent choice––one which both TRS and ERS have done––is to reset expectations to earthbound levels. Investors want to make as much money as possible: it is in the best interest of the financial teams for ERS and TRS to get as high returns as they can while still responsibly managing billions of dollars. Lowering the rate of return is, by extension, a wise choice because it offers a clear signal to lawmakers: fulfilling our promises has to come from other methods. The state has to find the money in order to make the pieces whole again.

We all know there are several reasons compounding ERS's problems. The public employee workforce has remained relatively static over the past two decades, all while the number of retired state workers has continued to grow; this artificially tight workforce makes it difficult to grow the pension system's contribution base to meet its growing demands. We also know that there is a constitutional cap on pension contribution rates by the state; even if one separates state contributions from agency contributions, we are near that 10 percent threshold. In many ways, we are made to believe that there is nothing that can be done.

But we do know that plenty of things can be done, however. The constitutional cap is not as hard and fast as it seems––indeed, the phrasing leaves a lot to interpret over what, exactly, ten percent means. The governor can always declare an emergency for the fund and override contribution caps. We can actually create a Legacy Fund from excess rainy day funds, in order to have a second set of investments that can ensure the resilience of the system. We can stop offering excessive tax breaks to massive corporations that can already afford to move here––and which dearly need our state for their growth. And we can look into the surplus we still have available in order to fill unfunded pension liability gaps.

We are now at a crucial junction with ERS: either step up and maintain the system's financial health, or be responsible for ill effects that will pop up down the line. We don't have to be in the same scenario as other states with infamous pensions. Texas is, thank goodness, not Illinois or New Jersey––and we don't have to have mismanaged pensions like the ones that plague their states.

Even though TRS is in a much healthier position that ERS, we also have to keep one eye on it as well. To be frank, having one of the largest pension systems in the world should necessitate making TRS a priority every session. We really want to stress that the welcome and necessary changes done during the last legislative session cannot be the final care TRS receives for the next few sessions. Ignoring TRS's needs in maintaining actuarial soundness risks putting this system in financial disarray.

We are well aware that the state has other tremendous needs it must address during the next legislative session. The COVID-19 pandemic has altered every aspect of our state's economy and day-to-day operations. Simply put: We don't see funding ERS and TRS as being in conflict with immediate pandemic and economic recovery responses. On the contrary, we see funding ERS and TRS as part of the complete set of choices the legislature must make in order to ensure the long-term economic health of the State and, more importantly, the wellbeing of its people.

Our public pension systems are giant economic engines in themselves. The overwhelming majority of money paid out in pension annuities stays in Texas––circulating funds all across the state. This circulation also multiplies the money: a pension check puts out much more

in economic value than its original cost. At a time where many communities are having difficulty keeping businesses afloat––and when many Texans are having difficulty making ends meet––pensions are serving as vital boosters for local and household economies alike.
We also believe that a healthy pension system is also connected to the overall health of our workers as they weather this crisis.

Further, healthy pensions will ensure the long-term health of our public sector, so that it can continue to provide essential services during the future, in both “normal” times and amid unforeseen circumstances. When coupled with livable wages, reliable pensions ensure that public employees stay for the long haul; it is one of the key ways to ensure people will make a full career out of their jobs. Pensions are also a key way to ensure that workers retire with security, and aren’t left working several extra years to pad out meager savings. This enables new generations of workers to come in at a healthy pace, ensuring the public mission and public service remains strong.

What we cannot do at this moment is kick the can down the road another two years. Wishful thinking that the economy will bounce right back into peak performance––that we will experience the mythical V-shaped recovery––will not only make the system even more expensive to solve, but may risk putting ERS in a very precarious situation. Again: we are not there yet, but every year without a true funding solution brings the pension closer to an unresolvable crisis.

Our pension systems are massive, and they are one of the key economic forces in our state. Having them fail is going to be much, much, much more expensive than maintaining their health.

Interim Charge 7:

The House Appropriations Committee has also been given the following task:

> Interim Charge 7: Identify structural changes that can be made to the Economic Stabilization Fund (ESF) in order to maximize investments and establish a source of funding for long-term liabilities. Examine the potential of using the fund for long-term infrastructure projects and the impact of the constitutional cap on the ESF balance.

First, as an aside, we realize that the committee itself is not in charge of whether or not it gets to convene a special session. That said, we find it rather dispiriting that the governor would choose to wait until January––when economic issues will either be more expensive to fix or will become unfixable altogether––to consider how to tap into the ESF.

That said, the issues with finding a best use for ESF funds run a bit deeper, particularly when it comes to ongoing issues related to pensions. We believe an opportunity was missed by not establishing a Legacy Fund out of the surplus money above what is necessary to maintain the Rainy Day Fund at a healthy level.

We know that challenges will always exist. There will always be unforeseen circumstances––whether a public health pandemic, a recession, or natural disaster. But this is why the Rainy Day Fund is already in place. Further, this is why nearly all members of the legislature agree that the Rainy Day fund should be stocked at a level to weather a considerable set of challenges: the jar should ideally be filled with several billion dollars.

But we were well beyond that point in 2019. What Representative Capriglione initially suggested for stocking the Legacy Fund––an idea echoed by the state comptroller's office––would not have put the integrity of the Rainy Day Fund at risk. In fact, by reinvesting that money separately and allocating it for legislatively-mandated purposes (including our two statewide pension systems), it would have quickly freed up the remaining Rainy Day Fund money for other purposes.

We know that whatever the shape of the economic recovery, it isn't going to be overnight. We also know that this recovery is bound to public health and the development of a consistent working vaccine for COVID. Both of these are going to take time, but they impact every element of our state's economic well-being. That includes our state pension systems. In fact, we cannot have an economic recovery from COVID without devoting some of our reserve funds to our pension systems.

For the long-term health of both our pensions and the state's economy, we maintain that a certain amount of Rainy Day Fund money should be reallocated in a separate investment corpus, the returns from which can be used to pay off any ongoing or future unfunded liabilities for ERS and TRS. The larger this initial investment corpus can be, the sooner its investment returns will have considerable results for maintaining the health of our statewide pension systems. By maintaining this separate investment corpus, our state can also ultimately use Rainy Day Funds for their intended purpose: addressing emergencies and unexpected circumstances.

If ESF money cannot be set aside for a separate Legacy Fund, then we recommend committing some of that money toward tackling the unfunded liability for ERS and TRS caused by the COVID pandemic. Neglecting our pensions as part of the recovery will only make it harder for the Texas economy to return to full form.

Thank you for your time and consideration. I look forward to hearing from you soon.

Sincerely,

Keegan Shepherd, Ph.D.
Policy Coordinator
Texas Pension Coalition

TEXAS PUBLIC EMPLOYEES ASSOCIATION

512 EAST ELEVENTH STREET
SUITE 100
AUSTIN, TEXAS 78701

To: Chairman Rep. Giovanni Capriglione and Members
House Committee on Appropriations
House Committee on Pensions, Investments, & Financial Services

From: Texas Public Employees Association (TPEA)
Ann Bishop, Executive Director
512. E. 11th Street, Ste. 100
Austin, TX 78701
512-476-2691
abishop@tpea.org

Date: September 16, 2020

Subject: Joint Interim Charge 2
ERS Pension Fund—Actuarial Soundness

On behalf of the 11,000 active state employee and retiree members of the Texas Public Employees Association, thank you for this opportunity to submit comments on Joint Interim Charge 2. This charge calls for a review and evaluation of the pension funds administered by the Employees Retirement System (ERS) and Teachers Retirement System, the cost and potential strategies for achieving and maintaining the actuarial soundness of the funds, and the state's investment policies with respect to the funds. TPEA's comments will be limited to the ERS portion of the charge.

Established in 1946, the Texas Public Employees Association is a voluntary, non-profit and nonpartisan organization to advocate for the interests of active state employees and retirees before the Legislature and executive branch of Texas government. In that year TPEA successfully promoted voter approval of the constitutional amendment creating the ERS pension fund. In 1975 TPEA led the effort to establish paid health care coverage through ERS for state employees. For almost 75 years TPEA has worked to provide competitive compensation to attract and retain qualified employees, preserve and improve retirement benefits for those who have dedicated their careers to public service, and protect and enhance health insurance benefits for active state employees and retirees.

Article XVI, § 67, Texas Constitution, directs the Legislature to finance benefits of the ERS Retirement Trust "on sound actuarial principles." But as you know, ERS's actuary, Gabriel Roeder Smith & Company, has estimated that, as of the end of FY 2019, the ERS Trust will run out of funds in 2061. Since 1999, ERS's funded ratio has declined from approximately 105% to about 70% today. The unfunded liability of the trust currently stands at $13.6 billion. Investment returns over the past 20 years have not met current assumptions, leaving the fund to rely more heavily on state and member contributions to make up the difference. Despite increasing contribution rates, however, actual contributions continue to lag actuarial contributions by nearly 4%. Even more troubling is the fact that ERS as a mature pension fund has almost as many retirees and beneficiaries taking money out of the trust as active employees paying in. This means not only that ERS is emptying the fund almost as quickly as it is replenished, but that the negative cashflow position reduces the amount remaining for long-term investment.

By contrast, in 2019 the Legislature infused TRS with more than $1.1 billion and raised the state contribution rate, restoring the fund to actuarial soundness and reducing the period for paying off TRS's unfunded liability from 90 to 29 years. TPEA applauds the Legislature for its forward-looking intervention on behalf of active and retired Texas teachers.

We now urge you to take similar action on behalf of your own workforce, the approximately 146,000 state employees who deliver the vital basic services necessary to keep the state economy up and running. The Legislature has every reason to be proud of the work your employees are doing every day. Despite the dizzying population growth in the state over the past 25 years, the number of state employees has remained the same since 1993. Rather than a bloated bureaucracy, Texas government is lean and efficient. Your employees work harder and smarter than in any other state in the country. They also show up in times of unprecedented crisis, as we are now experiencing. Despite thousands who have tested positive for the novel coronavirus, state employees continue to perform the jobs necessary to protect public health and safety, process desperately needed unemployment benefits, provide health care for the most vulnerable Texans, and serve the businesses and occupations that rely on them to keep the doors open. These men and women, many of whom are working under extreme duress, have earned your attention to the long-term viability of their hard-earned retirement benefits.

So, what should be done? At the very least, as it did last session with the TRS, the Legislature should make a substantial cash investment in the ERS Retirement Trust to stem the downward spiral and reduce the unfunded liability. Last session, for example, the House committee substitute for S.B. 500, the supplemental appropriations bill, allocated $150 million for ERS. If even this modest amount of funding had survived and been committed on an ongoing basis, it would bring the fund to actuarial soundness in approximately 15 years and, all other things being equal, would fully fund the trust in about 50 years. If the Legislature, however, commits the same amount to ERS in 2021 as it did to TRS in 2019, it would have a far bigger impact and establish ERS on a firmer financial footing going forward.

Second, the Legislature should consider adopting an actuarially determined contribution formula that adjusts contribution rates according to changes, positive or negative, in investment performance or liabilities. Currently, contribution rates can only be determined by the Legislature on a biennial basis. Making such a change would by no means remove the Legislature from control over ERS funding policy, but it would provide a reasonable fail-safe for determining actuarially appropriate funding targets and enable ERS to adapt to market conditions in a predictable way. Moreover, a contribution formula approach would go a long way toward satisfying the constitutional requirement that the trust be financed on an actuarially sound basis without the Legislature having to make expensive lump sum contributions to meet funding crises, such as the one we now face. In the long run, this approach will save taxpayer dollars by increasing the trust's investment revenues, strengthening the state's credit rating, and reducing interest costs on an unfunded liability that is growing at a clip of $750 million per biennium.

Doing nothing is a bad solution for everyone. A stable and financially sound retirement plan is one of the things that makes a career in public service more attractive. Remember that while the average state employee salary is about $48,000, almost two-thirds of state employees make less than that, and 25% make less than $36,000. State employee pay is generally uncompetitive with private sector employment, but that does not mean that we have to accept 20% employee turnover rates and the loss of 41% of new employees who move on within two years of entering service. No business could possibly operate this way for very long, no more can the business of state government. We are appreciative and cognizant of the fact that taxpayers pay the bills, but taxpayers also deserve a state government that is responsive to their needs and delivers services efficiently, promptly, and cost-effectively. If we do nothing to stop this terminal decline in the primary long-term benefit available to your workforce, we will come to a day when we have no workforce at all, at least not one that can do what the people of Texas want and expect it to do.

TPEA and its members stand ready to work with you next session to move ERS down the road toward the constitutional mandate of actuarial soundness. We understand that you will have very tough choices to make in the budget process come spring, but as our state grapples with the economic, social, and personal suffering brought on by the novel coronavirus, we cannot afford to leave behind those who put themselves on the line so that we can all pursue a better life. Thank you for your attention and for your dedicated service to our state.

ATTN: Pensions Investments and Financial Services Committee:

The Employee Retirement System (ERS) represents a commitment to State Employees as mentioned in our State Constitution and is a form of deferred compensation. A strong and secure retirement system is crucial for recruiting and retaining a competitive workforce. With historic turnover (19.3%) it is even more important than ever to strengthen our pension system. The State must uphold this promise and fully fund the pension system. Years of significant underfunding is the root cause of the current state of the fund, not mismanagement or sustainability.

The contributions to the plan have been increased (9.5% by State .5% by agency and 9.5% for employee). However, the funding has not met the Actuarily sound contribution level needed to fully fund the plan since the early 2000's. A total funding contribution of 25.33% is now needed to bring the ERS fund to Actuary soundness. Once the unfunded liability that has accumulated due to the underfunding is dealt with the fund only requires a contribution of 14.24% to cover the normal costs. This normal cost is well under the current 19.5% contribution level.

With the recent decision by the ERS board to lower the expected rate of return from 7.5% to 7% the fund is now expected to reach depletion in 2061.

The Texas Legislature must include a much-needed increase of 5.83% in the next budget to put the ERS pension back on track to full funding. Employees have already shouldered a heavy burden with a current contribution of 9.5% of their check.

During the 86th Legislature, Senator Nelson requested an opinion from the Attorney General regarding constitutional limitations on the legislature contributing more than 10% to the fund. The AG determined that since the constitution also requires the legislature to fund the pension to actuarily soundness and gives the Governor power to declare an emergency, that if a contribution over 10% is included in the budget and is signed by the Governor that would be sufficient.

It is dire that action be taken this session. Either by an increase to the State's contribution, a direct cash infusion, or a combination of both. Delaying adds billions to the cost and will hurt State Employees, Retiree's and the taxpayer.

Retirement Plan Demographics as of 8-31-19

	ERS
Active Contributing Members	141,865
Average Age	43.5
Average Entry Age	35.1
Average Years of Service	8.4
Average Annual Salary	$49,220
Non-contributing Members – Vested	15,425
Non-contributing Members – Non-vested	110,510
Retirees and Beneficiaries	115,155
Service Retirements	103,934
Average Age*	69.1
Average Age at Retirement*	59.1
Average Years of Service*	21.7
Disability Retirements	2,237
Beneficiaries	8,984
Average Annual Annuity	$20,645

Largest Contributing Agencies (based on membership)

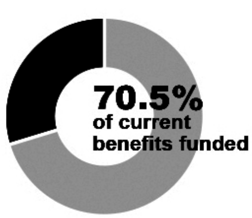
26%	25%	9%
Texas Health & Human Services Commission	Texas Department of Criminal Justice	Texas Department of Transportation

ERS Investment Performance (period ending 8-31-19)

Period	30-Year	20-Year	10-Year	5-Year	3-Year	1-Year
Annualized Return (Net)	N/A	5.83%	8.09%	5.99%	8.15%	3.00%
Annualized Return (Gross)	7.76%	5.92%	8.20%	6.03%	8.19%	3.04%

Employees Retirement System (ERS) - Plan Cost Impact of Newly Adopted Assumptions

As of August 31, 2019	Previous Assumptions and Methods	Newly Adopted Assumptions and Methods
Unfunded Accrued Liability	$11.7 billion	$13.6 billion
Funded Ratio	70.5%	67.3%
Funding Period	Never	Never
Projected Depletion Date	2075	2061
FY 2020 Normal Cost	13.76%	14.24%
FY 2020 Actuarially Sound Contribution (ASC)	23.26%	25.33%



- State employees
- Elected officials
- District attorneys
- LECOSRF members

IMPACT ON ERS PLANS: The following findings resulted in recommended changes that impact the previous funding status of the plans.The findings are ranked from the most to the least impactful and indicate whether a change would increase or decrease funding status

Key Findings	Impact of Assumption Change on Projected Funding Status
Lower expectations for nominal investment return going forward	Decrease
Lower expectations for future individual salary growth	Increase
Lower expectations for future overall payroll growth	Decrease
Lower expectations for law enforcement and custodial officers retirements	Increase
Higher expectations for law enforcement and custodial officers employment separation	Increase

RESPONSE TO TEXAS HOUSE APPROPRIATIONS COMMITTEE INTERIM CHARGE 2: "Review and evaluate the actuarial soundness of the Employees Retirement System and Teacher Retirement System pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds…"

1. **Employee Retirement System (ERS)**

   The ERS Pension Trust Fund was a strong, fully funded (104.9%) pension in 2001 that as of FYE 2019 was funded at 70.5% with a "Never" period to fully fund. In fact, the 2019 actuarial estimate of fund depletion was 2075, with a 25% chance of depletion by 2050. The actuaries reported that as of 2019 "The current financial outlook for ERS is very poor." While many factors (demographics, investment earnings, etc.) are part of the measurement model, one very key factor was the extended period of time when the State underfunded the ERS Trust Fund (1991-2011). While the current contribution rates were a result of increases bringing the State to 9.5% of compensation, the employee to 9.5% and the State Agency at .5% in recent years, the underfunding damage and accompanying loss of earnings on those reduced contributions over the years had taken its toll. And without an increase in contributions, the actuaries project increases to the unfunded liability of approximately $1 billion per biennium.

   Since the FY 2019 Actuarial Report, two significant things have occurred: (1) Economic/Investment Market downturn related to the Covid-19 pandemic and (2) the ERS Board recently lowered its assumed investment earnings rate from 7.5% to 7.0% - much more in line with future expectations. Regarding #1, ERS did take a hit, but has also had substantial recovery. And, earnings over time will go up and down. In #2, the ERS Board made a difficult, but very prudent decision, to not overstate future earnings and, as a result, not overstate the funded status of the ERS Trust Fund. <u>The adoption of the 7.00% investment return, along with other updated actuarial assumptions in May, now shows **ERS at 67.3% funded** with a **projected depletion date of 2061**, as of FYE 2019. Legitimacy and accuracy through more current assumptions are necessary, and the numbers from which to work should now be very valid – little to nothing material obscured!</u>

   There may "alternative" suggestions that materialize such as issuing pension bonds, or converting from a DB Plan to a DC Plan for new employees. Without dwelling on the problems of these, the former (if allowed) creates more State public debt and the latter only exacerbates the unsound current DB funded position jeopardizing the pension for those who remain on it.

   The answer – is NOT easy! It is time to "sink or swim" and sinking is not an acceptable answer. Supplemental funding from the State is a must! Being realistic in today's environment, a one-time forever fix is likely out of the question. But, <u>a long-term supplemental State appropriation plan, over several bienniums, will make needed progress toward soundness. It is our layperson understanding that this may require an ERS "emergency" declaration due to the constitutional maximum contribution rate limit of 10% from the State. We believe that the groundwork for this must start now. At this point, supplemental funding to control the ERS pension debt (UAAL) is mandatory.</u> **The legislature was warned as early as 2015** by then Executive Director Ann Bishop that "The Bond Houses do consider this a debt" – State credit ratings could be negatively affected.

2. **Teacher Retirement System (TRS)**

SB 12-2019 (Huffman, G. Bonnen, et al) was close to, if not a full, masterpiece, in taking appropriate steps to return to (and maintain) an actuarially sound TRS pension plan. It was logical, fiscally prudent, and equitable in its funding approach. It not only dealt with prompt funding action for actuarial soundness, it also established a 6-year increased funding plan to make it more realistic to retain future soundness with a UAAL funding period of less than 31 years. During this time period, the State contribution rate goes from 6.8% of compensation to 8.25%, the employee rate from 7.7% to 8.25%, and the public education employer from 1.5% to 2.0% - sound, logical, fair, and balanced!

Yes, TRS was also hit by the investment market valuation drop. But, due to its structural characteristics – "large, long-term, and liquid" – the fund is able to weather market drawdowns and it is also rebounding. Again, the market will go up and down, but the assumed investment earnings rate is established as a realistic average over time. The TRS Board had also been prudent in lowering its investment return expectation from 8% to 7.25% in 2018.

<u>At this point, the main objective for the coming (and subsequent) biennium(s) is to maintain the funding plan increases as legislated in SB 12. In spite of the financial challenges ahead, under-appropriation from the TRS statutory rates will only serve to return us to the same challenges faced in 2019. SB 12 will contribute to soundness and improve opportunities for benefit enhancements.</u>

Additionally, one of the alternatives previously noted – conversion of the DB plan to a DC plan for new employees – will increase the State's funding challenge (UAAL) of the remaining DB plan by approximately $15 billion and would put the plan in significant jeopardy for those remaining on the DB plan. This conversion has been proposed previously, fortunately with no traction, but will likely come up again. Understanding the whole 360° of the terrain is necessary – seemingly simple solutions can create complex problems!

3. **Epilogue**

Putting things in perspective, it is important to note that between ERS and TRS, there are currently about 550,000 retirees/beneficiaries receiving monthly pension payments. We estimate that this includes 10% (or more) of the Texas senior population that the Texas Silver-Haired Legislature represents. These are folks that have paid into their pension while working with the expectation of a secure, predictable pension in retirement. But, they not only receive pension payments, they also positively impact the State's economy through their consumer spending. They are important!

Submitted By: Scott L. Christensen
Brazos Valley Area Representative
Vice Chair – Legislative Action Committee
Texas Silver-Haired Legislature (TSHL)

Attachments: TSHL Resolution R032 (2020)
TSHL Resolution R033 (2020)

By: Scott Christensen, Nancy Byler, Sherry Hubbard, Paul Stempko, and Earl Wall **R033**

Committee: Retirement & Aging

Reject Conversion of Teacher Retirement System (TRS) Pension from Defined- Benefit (DB) to Defined-Contribution (DC) Plan

A RESOLUTION TO: Reject any, and all, proposed legislation to convert the TRS Defined-Benefit (DB) Pension Plan to a Defined-Contribution (DC) Plan.

WHEREAS, Conversion of the DB Pension Plan to a DC Plan for new employees would be very costly upfront, encounter extreme funding challenges endangering the long-term health of the existing DB Plan, and incur the cost to manage two systems; specifically:

- There would be an immediate addition to the DB unfunded actuarial accrued liability (pension debt), estimated at $15.5 billion (greater than the 2019 "Rainy Day" fund balance), as determined in a 2018 TRS Pension Design study, making the Plan unsound;
- The State would have to find new sources of funds to replace both the State and employee contributions lost from new employees participating in a DC Plan, or significantly jeopardize the annuity payments to future TRS retirees still on the DB Plan;
- Investment income (normally a source of well over half of TRS annual revenue) would decrease over time due to a decreasing investable balance in the TRS trust; and
- The State would need to operate two retirement systems for 50+ years, increasing operating costs; and

WHEREAS, The TRS DB Plan provides a secure method for TRS retirees to receive a monthly lifetime annuity payment, and, as of August 2019, the Pension's UAAL funding/amortization period for actuarial soundness was at 29 years (better than the 31 years statutory maximum). And, TRS has a plan through FY 2025 for an equitable and sound increase of funding contribution rates (SB 12 in 2019); and

WHEREAS, SB 12 (2019) has established a plan for ongoing, equitable management of State, employee, and employer contribution rates to maintain actuarial soundness of the DB Plan; now, therefore, be it

RESOLVED, That the 18th Texas Silver-Haired Legislature strongly urges the 87th Texas Legislature to reject any, and all, proposed legislation for the conversion of the TRS Defined-Benefit Plan to a Defined-Contribution Plan, for financial exposure and operating cost reasons, and to maintain a predictable pension security for TRS retirees.

PASSED AND APPROVED on April 27, 2020, by the Retirement & Aging Committee.

Irene Andrews

Irene Andrews, Chair

PASSED AND APPROVED on July 29, 2020, by the Texas Silver-Haired Legislature.

Rhonda Rogers

Rhonda Rogers, Speaker

ATTEST: Bobette Doerrie

Bobette Doerrie, Secretary

By: Scott Christensen, Nancy Byler, Sherry Hubbard, Paul Stempko Earl Wall, and Johnny Waldrip **R032**

Committee: Retirement & Aging

Supplemental Funding Plan for the State Employee Retirement System

A RESOLUTION TO: Establish a supplemental funding appropriation plan to strengthen the State Employee Retirement System (ERS) Pension and achieve actuarial soundness.

WHEREAS, ERS is a defined-benefit (DB) retirement plan established by constitutional amendment, funded by employee and State contributions and pension trust fund investment earnings, to provide a retirement annuity to ERS retirees; the State is capped on its constitutional maximum contribution rate of 10% of salary; and, the Pension is not actuarially sound by industry standards or statutory requirements - funded ratio of 70.5% and a "never funding" period of the pension UAAL (2019). The actuaries state, "The current financial outlook for ERS is very poor." This leads to the following:

- Lack of long-term retirement security for ERS-covered retirees; No COLA possibilities.
- State funding challenges that will only grow in significance over time if not addressed.
- Increased scrutiny/reputational risk with required GASB pension debt reporting.
- Potential risk of lowered credit ratings (higher borrowing cost) for State bonds; and

WHEREAS, "...the State failed to meet this (statutory ERS contribution rate) requirement in all but two years from 1988 through 2013. By one estimate, this cost the ERS pension fund more than $1.1 billion in contributions between 1991 and 2011 alone" (State Comptroller Fiscal Notes [Special Edition, March 2017]). And, a proposed $300 million supplement in 2019 was not approved. $1.1 billion (plus modest earnings since 2011) plus $300 million would have raised the 2019 funded ratio from 70.5% to approximately 75%; and

WHEREAS, other solutions, such as selling pension bonds, creates more Texas public debt - a practice that the GFOA does not recommend; and conversion to a defined contribution plan for new employees only increases the pension debt (UAAL), thus exacerbating the "never funding" of the UAAL for the State and the remaining DB pensioners; now, therefore, be it

RESOLVED, the 18th Texas Silver-Haired Legislature strongly urges the 87th Texas Legislature to respond to this emergency and establish a long-term annual supplemental funding plan to achieve sound ERS pension status, provide fund security for ERS retirees, reduce significant future State catch-up funding cost, and avoid potential ratings downgrades.

PASSED AND APPROVED on April 27, 2020, by the Retirement & Aging Committee.

Irene Andrews

Irene Andrews, Chair

PASSED AND APPROVED on July 29, 2020, by the Texas Silver-Haired Legislature.

Rhonda Rogers

Rhonda Rogers, Speaker

ATTEST: Bobette Doerrie

Bobette Doerrie, Secretary

September 7, 2020

To the Members of the Texas House Committee on Appropriations

Comments on Interim Charge 2 – Actuarial Soundness of the ERS Pension Fund

It is my hope this Committee is actually going to make a difference in the pension funding for the Employees Retirement System of Texas (ERS). I retired in 1999 with 35 years of service with the State of Texas. The last cost of living adjustment (COLA) I received was effective January 2002. There have been no annuity increases or 13th month checks for the past 18 years. I don't know how much longer I can wait since I'm now 78 years of age.

I'm not going to provide you with fancy charts or colorful graphs to reflect the underfunding of the ERS pension fund these many past years. (An article in the *Austin American Statesman,* dated February 6, 2015, Sen. Kirk Watson blames the Legislature for allowing the pension fund to be underfunded. He was quoted as saying it is **"the fault of the Legislature we're even having this discussion"**.) (Another article in the *Austin American Statesman,* dated May 14, 2015, reported, "The state first reported an unfunded liability in 2003, but it has grown exponentially since then amid insufficient contributions, the economic downturn and a dwindling workforce. The number of employees contributing to the plan has declined in recent years, while the number of retirees and beneficiaries has steadily increased over time".) **What data or information has been provided or used by the Legislature these past years to not address this ongoing problem?**

In the last session there was legislation to allocate $150 million to the ERS pension fund which did not pass. The Legislature instead prioritized new spending for public education, property tax relief, Hurricane Harvey relief and the Teacher Retirement System **(TRS)**. The Legislature appropriated $1.1 Billion to the TRS pension fund which allowed them to become actuarially sound and provide their retirees with a 13th month check in **2019**. TRS has also provided their retirees with a 13th month check in **2007** and a COLA in **2013.** Again**, ERS has made "NO" such payments to their retirees since 2002**.

Cities, counties and school districts take care of their employees, even if it means raising taxes. **It's time for the Legislature to take care of your employees.** Not every State employee lives in your District but you have constituents living in your District that interact with State employees on a daily basis. You certainly expect your employees to provide excellent customer service for your voters.

Your job is very simple. Adequately fund the ERS pension fund. State law requires an actuarially sound pension plan and for any unfunded liability to be paid off within 31 years. **STOP** kicking the can down the road. It appears the road is fast approaching a **DEAD END**.

Thank you for your service to the citizens of the State of Texas.

Improving ERS Investment Performance, I Hope You Do Something
By Stuart Greenfield, Ph.D., 3029 Thrushwood Dr., Austin, TX 78757; 512-796-4105

In 1977 I was hired by Mr. Bullock to work in Revenue Estimating as Chief Economist and Revenue Estimator. One thing that was instilled in everyone who worked for Mr. Bullock was that what you do should be to benefit the people of Texas. This philosophy underlaid the work I did throughout my career at the state.

It appears from their performance, documented below that neither the ERS Board nor the investment staff had or have this simple philosophy. This philosophy, your actions should be to benefit the people of Texas, does not seem to underlie the investment activities associated with the ERS trust fund.

Two years ago, Scott Burns analyzed the performance of state and local pension funds. Using data from the Comptroller's Office, Mr. Burns compared the performance of various state and local pension funds to his "couch potato" portfolio that is replicated by Vanguard's VBIAX fund.

Mr. Burns' analysis showed that none of the public pension funds performed as well over ten years (FY07-FY17) as the Vanguard fund. Over the ten-years, the differential ranged from -0.96 percent per year for the Teacher's Retirement System to -2.23 percent for the Texas County & District Retirement System.

Table 1: The ERS and TRS Pension vs. Vanguard Balanced Index Admiral Shares

Period	ERS	TRS	Vanguard Balanced Admiral Shares
1	3.04%	6.40%	8.24%
3	8.19	9.5	8.04
5	6.03	6.7	7.25
10	8.20	9.9	9.94

Source: ERS, page 102; TRS, page 110; Vanguard

Had ERS invested the corpus and contributions made by both state employees and by the state over the last ten years in VBIAX, the overall return on assets would have been 18.8 percent greater. This increase would have increased the actuarial value of ERS assets by 3.8 billion to $31.9 billion. This increase in assets would also reduce the Unfunded Accrued Liability (UAL) from $11.7 billion to $7.9 billion, a 32.5 percent decrease. The funded ratio would have increased from 70.2 percent to 82.8 percent. While having a positive impact on the system, this change would not be enough to allow ERS to either provide a 13th check or a cost-of-living adjustment (COLA).

Fortunately, there would have been a way to eliminate the unfunded liability, and it was right in front of the ERS investment advisors and staff eyes. The way is presented on page 103 of the ERS, 2019 Comprehensive Annual Financial Report (2019 CAFR), which is shown below.

Table 2: Time-Weighted Rates of Return, ERS

	Time-Weighted Rates of Return (Note A)							
						3 Year	5 Year	10 Year
	2015	2016	2017	2018	2019	(2017-2019)	(2015-2019)	(2010-2019)
	%	%	%	%	%	%	%	%
Fixed Income								
ERS	1.29	5.14	3.49	1.19	6.57	3.73	3.52	3.95
Index	1.13	6.50	1.34	(0.93)	10.08	3.39	3.55	4.31
Domestic Equities								
ERS	1.55	8.48	15.81	20.89	(0.01)	11.87	9.05	13.04
Index	0.49	12.54	15.87	20.06	1.72	12.27	9.86	13.42
International Equities								
ERS	(9.86)	1.44	19.38	3.72	(2.96)	6.31	1.90	5.27
Index	(12.35)	2.92	18.88	3.18	(3.27)	5.87	1.37	4.71
Alternative Investments								
ERS	7.89	6.76	11.26	12.50	6.47	10.03	8.94	11.50
Index	NA	NA	NA	NA	NA	NA	NA	NA
Cash Equivalents								
ERS	2.71	0.76	1.91	2.72	2.16	2.27	1.85	0.77
Index	0.03	0.23	0.62	1.52	2.36	1.50	0.95	0.52
ERS Overall								
ERS	0.49	5.32	12.15	9.58	3.04	8.19	6.03	8.20
Index	(1.03)	7.23	11.08	7.94	3.06	7.31	5.57	7.89
Change in CPI	0.21	0.87	1.74	3.01	1.81	2.19	1.53	1.78

Source: ERS, 2019 CAFR, pg 102

Before discussing the solution, one needs to have an idea of the time a state employee would be expected to receive an annuity from the state. If we assume that someone starts working at the state at age 25 and works 30 years, retiring at age 55, how long should ERS expect to provide a monthly check? According to the Social Security Administration's Actuarial Life Table, a male retiring at age 55 would be expected to live to 80.5 years. A female retiring at the same age would live another 29 years. So the investment horizon for ERS should reflect the life expectancy of a thirty-year retiree, which would be between 25 and 30 years.

Given this time horizon, ERS should be focusing its investment on which would provide the highest risk-adjusted long-term return. As shown in the table above, this would be domestic equities. If ERS followed their domestic equity "strategy" or just invested in the **Index** (S&P 1500/S&P 1500 Blend) used to evaluate the ERS domestic equity portfolio, ERS's overall rate of return would have increased substantially. Had ERS invested all funds in their domestic equities index, the ten-year return on investment would have improved by 4.84 percent per year compared to the 10-year ERS Overall return of 8.20 percent (13.04 percent – 8.20 percent = 4.84 percent). Had they just purchased the Domestic Equities Index, there would have been a 5.22 percent per year improvement.

A 4.84 percent per year increase in the rate of return for ten years would have increased the fund's actuarial asset value by 60.4 percent. This increase ($17.0 billion) would have resulted in the actuarial asset value rising to 45.0 billion.

The investment fees associated with purchasing an index fund would be markedly less than the $176.1 million (66 basis points) ERS paid in 2019. The fee for the Vanguard VBIAX is seven basis points. Reducing investment expenses by 59 bp/year for ten years would increase the fund's asset value by $1.7 billion (6.0 percent).

Increasing returns and reducing investment fees would result in an increase in 66.4 percent in the actuarial value of assets from $28.1 billion in 2019 to $46.7 billion. As you'll note from page 117 of the ERS CAFR, $18.6 billion in additional Actuarial Value Assets would result in your Funded Ratio increasing from 70.5 percent to 114.8 percent.

Oy Vey, what is required for you to realize that over your investment horizon buying the market and eliminating a $100 million-plus in investment fees per year is the appropriate strategy. Look at the recent Scott Burns article evaluating TRS's performance. As shown in Table 1, TRS's performance in FY19 was twice the ERS performance. An article in Monday's Institutional Investor indicated that private equity had not been a sterling performer.

While I am not an actuary, I would hope that this Committee has their staff and that the ERS Board have the ERS investment staff, its actuary, and Investment Advisory Committee review my analysis. Assuming my math is correct, I would hope this would motivate the Legislature modify Sec 815.3016 so the ERS board would have to reverse its policy of placing more dollars in alternative investments and allocate the funds into a market index fund.

Another alternative might be considering outsourcing investments to the Nevada PERS. As you'll note from the table below, the Nevada PERS over the past five and ten year periods has done 150 bp better than ERS. One hundred-fifty bp over ten years would have resulted in a cumulative increase of 16.1 percent, not too shabby.

Table 3: Rates of Return, Nevada PERS, through June 2020

Asset Class	Sub-Asset Class	Market Value (Millions)	Target Allocation	Actual Allocation	FYTD Return	One Year	3 Years	5 Years	10 Years	Since Inception
U.S. Stocks	S&P 500 Index	$ 19,569	42.0%	42.0%	7.4%	7.4%	10.7%	10.7%	14.0%	10.2%
	Total U.S. Stocks	**$ 19,539**	**42.0%**	**42.0%**	**7.4%**	**7.4%**	**10.7%**	**10.7%**	**14.1%**	**11.1%**
	Market Return				**7.5%**	**7.5%**	**10.7%**	**10.7%**	**14.0%**	**11.3%**
International Stocks	MSCI World x US Index	$ 8,808	18.0%	18.9%	-5.0%	-5.0%	1.2%	2.4%	6.1%	5.5%
	Total Intl. Stocks	**$ 8,809**	**18.0%**	**18.9%**	**-5.0%**	**-5.0%**	**1.2%**	**2.4%**	**6.1%**	**5.2%**
	Market Return				**-5.4%**	**-5.4%**	**0.8%**	**2.0%**	**5.7%**	**4.7%**
U.S. Bonds	US Bond Index	$ 12,750	28.0%	27.4%	10.2%	10.2%	5.5%	4.0%	3.7%	5.1%
	Total U.S. Bonds	**$ 12,750**	**28.0%**	**27.4%**	**10.2%**	**10.2%**	**5.5%**	**4.0%**	**3.8%**	**7.3%**
	Market Return				**10.2%**	**10.2%**	**5.5%**	**4.0%**	**3.7%**	**7.2%**
Private Markets	Private Real Estate	$ 2,116	6.0%	4.5%	3.6%	3.6%	7.0%	7.4%	10.1%	7.6%
	Private Equity	$ 2,644	6.0%	5.7%	5.5%	5.5%	13.6%	13.9%	14.6%	12.7%
	Total Private Markets	**$ 4,759**	**12.0%**	**10.2%**	**4.7%**	**4.7%**	**10.4%**	**10.6%**	**12.3%**	**9.7%**
	Market Return				**7.4%**	**7.4%**	**9.9%**	**10.5%**	**13.2%**	**7.8%**
Cash		$ 718	0.0%	1.5%						
	Total PERS' Fund	**$ 46,575**	**100.0%**	**100.0%**	**7.2%**	**7.2%**	**8.1%**	**7.7%**	**9.6%**	**9.3%**
	Market Return				**6.4%**	**6.4%**	**7.6%**	**7.4%**	**9.5%**	**9.1%**

Source: Nevada Public Employees Retirement System, Investment Performance

According to the above, the Fiscal YTD return for the Nevada PERS was 7.2 percent. The 7.2 percent return compares to the 0.1 percent, YES 0.1 percent total fund return for ERS. Pay more get less is the hallmark of every public trust fund.

Table 4: ERS Total Fund Performance Detail (Net of Fees)

	Market Value($)	3 Mo(%)	YTD(%)	Fiscal YTD(%)	1 Yr(%)	3 Yrs(%)	5 Yrs(%)	10 Yrs(%)
Total Fund	27,435,810,375	6.1	-4.5	0.1	0.3	5.1	5.4	7.8
Total Fund Policy Index		8.9	-1.6	3.6	3.2	5.6	6.0	7.9
Long Term Public Index		15.6	-3.5	4.8	3.6	5.9	5.9	8.1

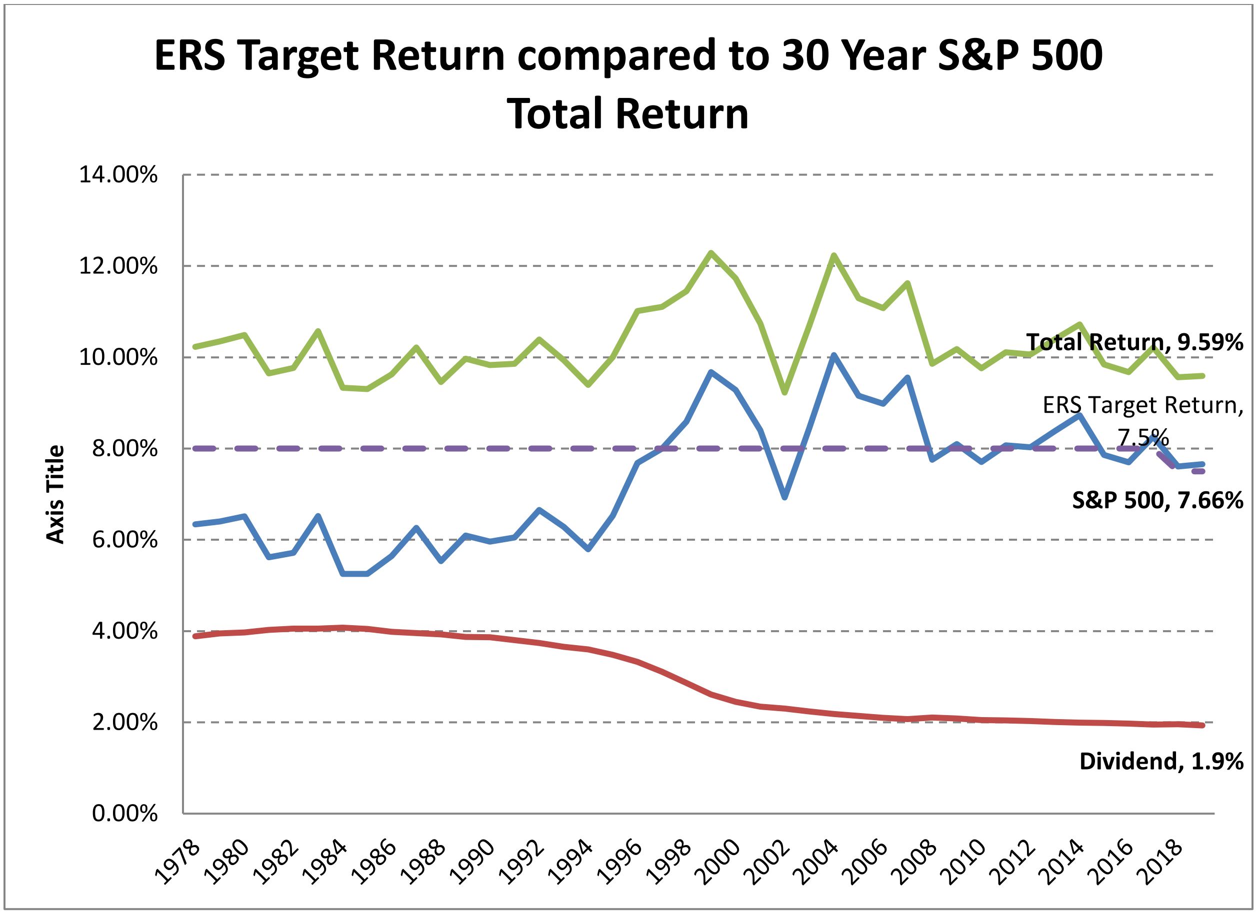
- **One-year ended June 30, 2020, the Fund underperformed the policy benchmark by 2.9%.**
- **The Fund's assets decreased to $27.44 billion from $28.67 billion in the last calendar year which includes an investment gain of $76.49 million for the year.**

Source https://agendasuite.org/iip/erstexas/file/getfile/1378, pg 86

The members of the Committee should find Scott Burns's recent analysis of all ninety-nine public pension funds in Texas. Only three of the 99 were able to beat the Vanguard Balanced Index fund. ERS ranked 39th. I assume that being in the top forty percent is not something the members find desirable.

Until recently, ERS had specified that an 8.0 percent rate was required for the fund to remain actuarily sound. In 2017 the board reduced this return to 7.5 percent. The chart below shows the 30-year S&P 500 return, the 30-year S&P 500 dividend return, and the 30-year S&P 500 total return.

ERS was created in 1948. Starting in 1978, I computed the return one would have earned for every 30 years since the creation of ERS, in both the S&P 500 and also the dividend yield. The sum of these is the total return. As you'll note, the 30-year total return has exceeded the ERS target return for every year since 1978.



Source: Historical Returns on Stocks, Bonds and Bills - United States

For most of the 21st century, just the S&P 500 returns exceeded the target return. Buying the S&P 500 would substantially reduce the investment fees that ERS has provided to enrich investment advisors whose performance is below the S&P 500 return. ERS spending on investment fees would be markedly reduced from the $176.1 million that was spent for underperforming institutions.

When the Legislature enacted Sec. 815.3016, APPROVAL OF CERTAIN ALTERNATIVE INVESTMENTS, you authorized the pension funds to invest in alternative assets. So please have the ERS Trustees to ask/direct their Investment Advisory Committee and investment staff to review the "alternative investment" strategy now in place. To benefit all stakeholders improving returns would be the most beneficial. Had they invested in the S&P 500, everyone, but the investment advisors would be better off.

With improved returns, the contribution by the state and current employees could be reduced. I would expect that both parties would be overjoyed with a reduction in their contribution rates. Future retirees and current retirees younger than me would also benefit from improved performance. Receiving an annuity adjustment over the 25-30 years, you'll be paying benefits to each retiree would be helpful. And finally, retirees like me who have not seen an adjustment since the beginning of the century might find a supplement in their payment.

Notes:

Burns, https://couchpotatoinvesting.com/couch-potato-investing-versus-texas-state-pension-funds/

Comptroller Pension DB, https://comptroller.texas.gov/application.php/pension/search

Morningstar VBIAX https://www.morningstar.com/funds/xnas/vbiax/betaquote.html

Pew Trust, https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2018/state-retirement-fiscal-health-and-funding-discipline#/state-profiles/texas?year=2016 and

https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/09/state-public-pension-funds--investment-practices-and--performance-2016-data-update

Governing, http://www.governing.com/topics/finance/gov-pensions-fees-pew-charitable-trusts-report.html

S&P 1500, https://etfdb.com/index/sp-composite-1500-index/#dividends&page=1