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Texas House Committee on Pensions, Investments and Financial Services

Request for Information on Interim Charge #4: 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 Appropriations)

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.

Exhibit 1: Strategic Asset Allocation

