28 August 2020

To the Members of the Committee:

The Texas Pension Coalition is writing with regards to Interim Charge 4 for the Texas House's Pensions, Investments, and Financial Services Committee.

As stated, 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. The irony is that the normal cost for ERS is relatively low:

14.24%. Returning ERS to an actuarially sound state would drive down overall costs to maintain the system given the pension system's low normal cost.

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 situation.

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

Sincerely,

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