



RSA Presentation to the Joint Committee on Alabama Public Pensions

January 14, 2016

Introduction



- ▶ Answer questions from members of the Joint Committee
 - ▶ Explanation of the assumed rate of return
 - ▶ Board make-up and experience
 - ▶ Litigation arising from reforms
 - ▶ Cost and risk of alternative plan design
 - ▶ General policy considerations and questions



RSA's Assumed Rate of Return



- ▶ The assumed rate of return is adopted by the Boards of Control upon the **recommendation of the actuaries** after completion of the five-year experience study, which includes a **capital market assumptions analysis** based on capital market data provided by RSA and the asset allocations as set by the Boards.
- ▶ The assumed rate of return is the assumption actuaries make about average earnings in the future and a **discount rate**, currently **8%**, which is used to discount to present value the amount of projected benefits the employer will have to pay. The present value of those benefits is used to calculate the employer rate.
- ▶ The **assumed rate of return** is **NOT** a guaranteed amount of interest due to RSA members every year.

RSA's Assumed Rate of Return



- ▶ The goal of the plan is to have a discount rate **as close to actual average returns as possible**.
 - ▶ If set **too high**, can result in **unfunded liabilities** -- employer pays too little.
 - ▶ If set **too low**, results in overfunding -- **employer pays too much**.
- ▶ The assumed rate of return will be reassessed during the next five-year experience study to be completed at the end **2016**.

RSA's Rate of Return: Actuarial Standards



- ▶ Actuarial Standard of Practice (ASOP) No. 27, "Selection of Economic Assumptions for Measuring Pension Obligations", provides guidance to actuaries in selecting economic assumptions for measuring obligations under defined benefit plans and was revised in September 2013. The revised standard now requires that each economic assumption selected by the actuary should be reasonable which means it has the following characteristics:
 - ▶ It is **appropriate** for the purpose of the measurement;
 - ▶ It reflects the **actuary's professional judgment**;
 - ▶ It takes into account **historical and current economic data that is relevant as of the measurement date**;

RSA's Rate of Return: Actuarial Standards, cont'd



- ▶ It reflects the **actuary's estimate of future experience**, the actuary's observation of the estimates inherent in market data, or a combination thereof; and
- ▶ It has **no significant bias** (i.e., it is not significantly optimistic or pessimistic), except when provisions for adverse deviation or plan provisions that are difficult to measure are included and disclosed, or when alternative assumptions are used for the assessment of risk.
- ▶ Each economic assumption should individually satisfy this standard. Furthermore, with respect to any particular valuation, each economic assumption should be consistent with every other economic assumption over the measurement period.

(Emphasis supplied.)

RSA's Assumed Rate of Return

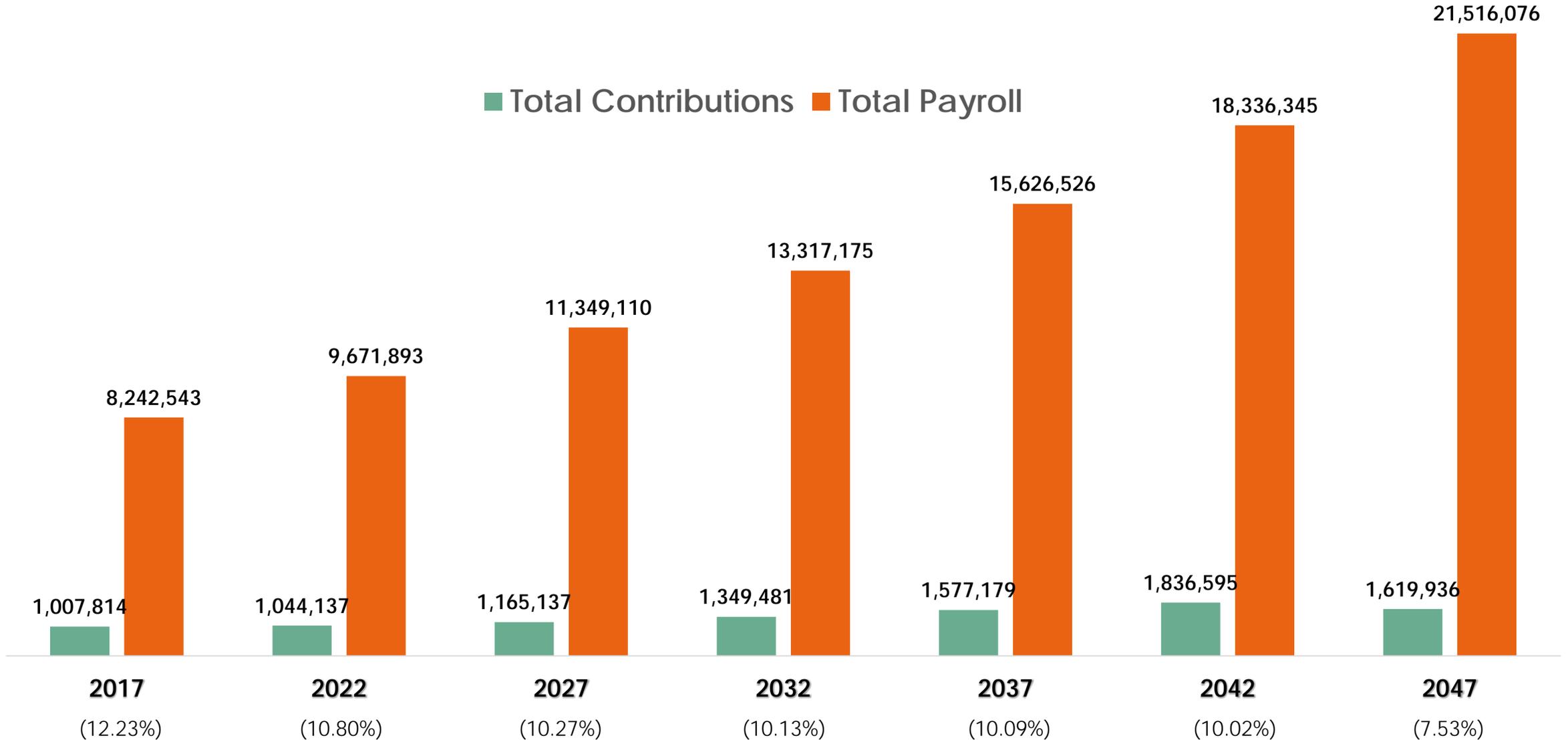


- ▶ Thus, if the assumed rate of return is lowered, **employer costs will go up** and the unfunded liability will rise.
- ▶ Public pensions go through this process and **over 30%** still use an assumed rate of return of 8%. As of December 2015 the median **assumed rate of return is 7.5%**. See NASRA Issue Brief, Public Pension Plan Investment Return Assumptions, December 2015.
- ▶ The assumed rate of return is reassessed by the actuaries at least every 5 years.

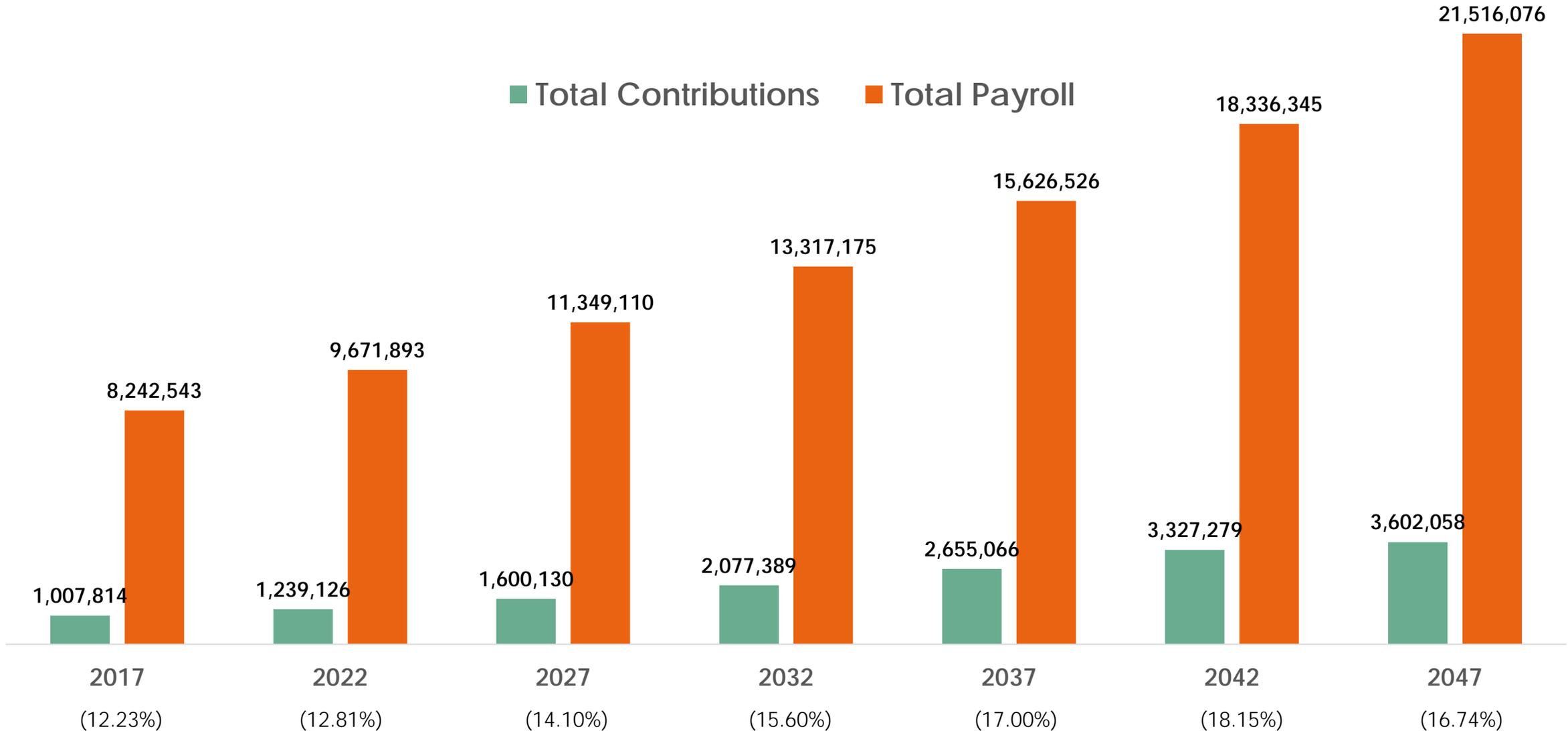
Comparison of Total Employer Contributions to Total Payroll Assuming 8% Investment Return



■ Total Contributions ■ Total Payroll



Comparison of Total Employer Contributions to Total Payroll Assuming 6% Investment Return



RSA's Historical Rates of Return – 35 yrs



	1 Yr	3 Yr	5 Yr	10 Yr	15 Yr	20 Yr	25 Yr	30 Yr	35 Yr
ERS	1.05%	9.06%	9.37%	5.16%	4.78%	6.46%	7.69%	8.04%	8.75%
TRS	1.04%	9.20%	9.42%	5.41%	5.10%	6.66%	7.85%	8.18%	8.81%

The returns for years 1980 through 1989 are based upon performance returns calculated from TRS' and ERS' historical financial statements, which do not weigh cash flows or asset allocation shifts that may have occurred within a given period. These years along with the years 1990 through 1995 were calculated by RSA staff. Returns for all years thereafter were obtained from State Street based upon TRS' and ERS' data.

ERS Board Composition



ERS Board: 13 members

[4 Ex Officio, 6 State (3 elected, 3 appted), 3 Local (elected)]

Ex Officio (all full voting members)

1. **Governor** - Chairman
2. **Treasurer**
3. **Finance Director** - statutory member of Investment Committee*
4. **State Personnel Director**



*Three person investment committee approves all investments as within the investment policy set by the Board. Information on all trades and investments are transmitted daily to the Investment Committee.

ERS Board Composition – cont'd



5. **Governor State Employee Appointee Place 1: Curtis Stewart:** 3 years on Bd. B.S., Accounting, C.P.A. Deputy Commissioner, AL Dept. of Rev., Dir. Of Tax Policy and Research. Previously, 7 years exp. as staff accountant and auditor for KPMG.
6. **Governor State Employee Appointee Place 2: Chris Blankenship:** 3 years on Bd. B.S. Criminal Justice. Director, Dept. of Conservation and Natural Resources, Marine Resources Division. Member of large number of law enforcement and fisheries, ocean, and port committees and task forces.
7. **Governor State Employee Appointee Place 3: Wendy Hester:** 3 years on Bd. B.S. Accounting. Chief Audit Executive, ADECA. Certified Internal Auditor, Certified Fraud Examiner, Certified Internal Control Auditor, and Certificate in Forensic Accounting

ERS Board Composition – cont'd



8. **Elected Retired State Employee: Jimmy Rowell:** 6 years on Bd. B.S. Mathematics and Business, M.B.A., State Finance Director under 2 Governors. Pres. Alabama Retired State Employees Association.
9. **Elected Active State Employee: Steve Walkley:** 20 years on Bd. B.A., Masters in Public Admin., J.D., member AL Bar. Division Director of the ADECA Workforce Dev. Division. Retired Army Reserve Colonel.
10. **Elected Active State Employee: David B. Bollie:** 4 years on Bd. B.S Civil Engineering, M.B.A., Reg. Professional Engineer. Project Director at AL Dept. of Transportation. Taught Finance at Auburn Univ. Montgomery.

ERS Board Composition – cont'd



11. **Elected Retired Local Gov. Employee: Jim Fibbe:** 7 years on Bd. B.S. and Masters, Civil Engineering. Retired as Executive Director Mobile Water/Sewer System. Auburn University Basketball's Living Legend. Former Pres. and Bd Member Alabama Retired State Employees Association.
12. **Elected Active Local Gov. Employee: Steven W. Williams:** 6 years on Bd. Attended Pensacola Jr. College. Certified Journeyman Electric Lineman, a Certified Level 2 Traffic Signal Technician. Employed 23 years with City of Robertsdale. Retired Volunteer Fire Captain.
13. **Elected Active Local Gov. Employee: Ben Powell:** 8 years on Bd. B.S. Business Admin., Certified Government Financial Manager (CGFM) and Certified Internal Auditor (CIA). City of Hoover's Director of Purchasing.

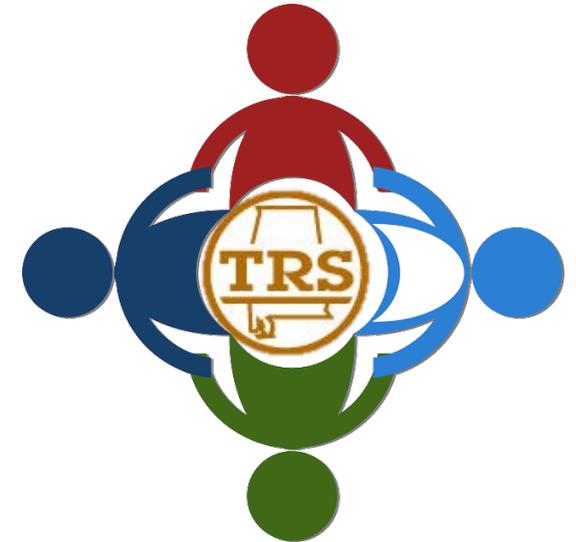
TRS Board Composition



TRS Board: 15 members (3 Ex Officio, 12 elected)

Ex Officio (all full voting members)

1. **Treasurer**
2. **Finance Director** - statutory member of Investment Committee*
3. **State Superintendent of Education**



*Three person investment committee approves all investments as within the investment policy set by the Board. Information on all trades and investments are transmitted daily to the Investment Committee.

TRS Board Composition – Cont'd



Elected TRS Board Positions:

4. **Higher Education (Univ.) Place 1: C. Ray Hayes:** 2 ½ years on Bd. Exec. B.S. and M.B.A. Vice Chancellor for Finance and Operations of the Univ. Of Ala. Systems. Manages \$5 billion budget. Former VP for Finance and Admin. at MSU and Exec. VP for Finance and Admin. at Texas A&M –C.C. Leadership roles with NACUBO and other prof. orgs.
5. **Higher Education (Univ.) Place 2: Dr. Donald L. Large, Jr.:** 1 ½ years on Bd. B.S. Accountancy, C.P.A., Masters and Ph.D. in Higher Education Administration. Exec. V. Pres. Auburn University, formerly V.P. for Business and Finance and CFO, and Controller. Formerly with Deloitte, Haskins and Sells, auditing consulting for Fortune 500 companies, universities, financial institutions, etc.

TRS Board Composition – Cont'd



6. **Postsecondary Place: Dr. Susan W. Brown:** 15 years on Bd. B.S. and Masters in Mathematics. Ed.D. in Curriculum and Instruction. 32 year Educator. Mathematics Instructor at Gadsden State Comm. College since 1990. Multiple leadership positions in education professional associations and community organizations.
7. **Superintendent's Place: Luke Hallmark:** 7 years on Bd. B.S. Degrees in Business Admin. and Secondary Educ., Masters in Educ. - Principalship, Ed.S. Administration. Candidate for Ph.D. in Educ. Admin. On Boards of School Superintendents of Alabama, Council for Leaders in Alabama Schools, Marion Military Institute Presidential Advisory Council, and the Alabama High School Athletic Association.

TRS Board Composition – Cont'd



8. **Principal's Place: Richard "Dickie" Brown:** 1 ½ years on Bd. B.S. Physical Educ. and Biology, Masters and Specialist degrees in Administration. 47 years in Educ., 36 as a Principal. Board member of AASSP, CLAS, and AHSAA Central Bd. of Control. State Principal of the Year (2006), AHSAA Making a Difference Award (2013), Smiths Station Hall of Fame (2006), BHS football field named Richard L. Brown Field (2006), and Alabama High School Sports Hall of Fame (2014)
9. **Teacher Place 1: Teresa Swindall:** 12 years on Bd. B.S. Special Ed. 22 years teaching experience. Past Pres. and other leadership positions with Etowah Education Assoc. Past Pres. Altrusa International of Gadsden.

TRS Board Composition – Cont'd



10. **Teacher Place 2: Ricky Whaley:** 6 ½ years on Bd. B.S., Masters, and A.A. in Agribusiness Educ. Educ. Administration Certification. 30 years teaching Agribusiness. 1990 National Outstanding Young Agriculture Teacher, Region V, 1993 National Outstanding Agriculture Teacher, Region V, and 1994 National Outstanding Agriculture Program, Region V.
11. **Teacher Place 3: Charlene McCoy:** 3 ½ years on Bd. B.S, Masters and EDS in Biology. 25 years as teacher in Etowah County School System, 10 years as Adjunct Instructor at Gadsden State Community College. 3 terms Pres. of the Etowah Education Association. Numerous awards for Environmental Ed., including Alabama Power Teacher Grant (3), and Alabama Pals State Award Class Project (5).

TRS Board Composition – Cont'd



12. **Educational Support Place 1: Susan Lockridge:** 2 ½ years on Bd. B.S. in Business. Software Specialist Huntsville City Schools. Graduate of the I.T.T. Financial Management Training Program and Financial Branch Management Institute. Past President of Madison Business Assoc., past pres. of the American Institute of Banking, past president of the Internal Auditor Association. 30 years exp. In finance and technology.
13. **Educational Support Place 2: Russell Twilley:** 3 ½ years on Bd. Voc. Ed. and course work towards accounting degree. STI Coordinator (information technology) for Walker County Bd. of Education. Pres. Walker County Support Professions Assoc.

TRS Board Composition – Cont'd



14. **Retired Place 1: Sarah Swindle:** 25 years on Bd. B.S. and Master's degree. 33 years teaching experience. Member and leader in various education assoc. Former Pres. of AEA and Jefferson County Ed. Assoc., 15 years Vice-Chair and 3 years as Chair of Board.
15. **Retired Place 2: Joe Ward:** 1½ years on Bd. B.S. and Master's Admin., classroom teacher then 33 years with AEA. VP of AL Education Retirees Assoc. Member AL Senior Citizens' Hall of Fame.

Litigation



RSA Defends Litigation Challenging Changes in the Benefit Laws or Policies:

Since January 2012, **9** cases have been litigated against ERS, TRS or PEEHIP or a local unit alleging either that:

- 1) A 2012 statutory reform is **unconstitutional**,
- 2) ERS or PEEHIP has to **refund money** to members because of a change in the law or in benefits,
- 3) **The State is liable** for a local unit's retirees' benefits, or
- 4) The court should oversee the **investment staff's investment decisions**.

Litigation



Results:

1. **Successfully defended changes** in the law limiting the amount of overtime compensation that can be credited towards retirement benefit and/or seeking refunds based on change in law. (4 cases)
2. Assisted in the **successful defense of the increase in employees contribution**. (1 case resolved, 1 pending against ERS)
3. **Successfully defended claims for monetary damages** allegedly resulting from change in premium structure for PEEHIP. (1 case, partially pending on motion for Summary Judgment, remainder decided in PEEHIP's favor)

Litigation



Results – cont'd

4. Successfully defended case in which local unit sought to **shift liability for its retirees benefits to the State of Alabama**. (1 case, resolved in favor of ERS)
5. Successfully defended the ability of investment staff to make **investment decisions under the Prudent Man standard** without court oversight. (1 case)
6. So far, 5 appeals to Supreme Court in the above cases – **Prevailed in 4, 1 pending**.

Comparison of Tier I and Tier II Benefits



Tier I Retirement Benefits

- ▶ 7.5% Employee Contribution Rate*
- ▶ Retirement with 25 years of service at any age or age 60 with at least 10 years of service.
- ▶ 2.0125% Retirement Benefit Factor
- ▶ Average Final Salary – average of the highest 3 out of the last 10.
- ▶ Earnable Compensation not to exceed 120% of base pay.*
- ▶ No Benefit Cap.

Tier II Retirement Benefits

- ▶ 6.0% Employee Contribution Rate
- ▶ Retirement at age 62. No 25 year service retirement.
- ▶ 1.65% Retirement Benefit Factor
- ▶ Average Final Salary – average of the highest 5 of the last 10.
- ▶ Earnable Compensation not to exceed 125% of base pay.
- ▶ Benefit Cap of 80% of Average Final Salary.

* Changes that affected current employees.

2017 Tier II Employer Contribution Rate



	ERS State Tier II Employer Rate	TRS Tier II Employer Rate
Unfunded Liability Rate	12.51%	9.65%
Normal Cost Rate	0.37%	0.81%
Administration, Death Benefit, and Term Life Rates	0.37%	0.36%
Total Rate:	13.25%	10.82%

The Tier II reforms are projected to save over \$4 billion over the next 30 years. This is due to the reduction in benefits that is reflected in the lower normal cost rate.

Cash Balance Plans and Excess Gain-Sharing



- ▶ Excess gain-sharing can be a feature in a cash balance plan that allows for the split of gains in excess of the promised interest credit between the employer and employee.
- ▶ Excess gain-sharing can be a way to provide a more meaningful benefit with a lower normal cost paid by the employer.
- ▶ However, **excess gain-sharing provisions in cash balance plans can actually increase the employer's investment risk.**

Cash Balance Plans and Excess Gain-Sharing: The API Model



- ▶ In a paper released in March 2015, API modeled a cash balance plan, which provided that the employer would provide a 5% annual interest credit with a split of excess gains of 75% to employees and 25% to employers.
- ▶ In order to determine the risk of the excess gain-sharing provisions, the actuaries ran projections for a cash balance plan that provided a 5% interest credit and a 75/25 excess gain split. The actuaries assumed that the actual rates of return for TRS/ERS during the years of 2001-2007 would occur during the projection period, for both the cash balance plan and the current Tier II plan.
- ▶ These returns were run forwards and backwards to produce two different investment return scenarios.
- ▶ Under both investment return scenarios, **the cash balance plan had higher unfunded liabilities than the Tier II plan.**

ERS and TRS Projected Unfunded Liability as of 2044



ERS	Tier II	Cash Balance	TRS	Tier II	Cash Balance
Investment Return Scenario 1*	(401,453,000) ^{***}	162,823,000	Investment Return Scenario 1*	(2,444,548,000) ^{***}	850,099,000
Investment Return Scenario 2**	350,866,000	499,464,000	Investment Return Scenario 2**	2,081,939,000	3,113,874,000

* Investment Return Scenario 1 assumes future investment returns are the same as RSA's investment returns from 2001-2007 starting first with the 2001 return.

** Investment Return Scenario 2 assumes future investment returns are the same as RSA's investment returns from 2001-2007 backwards starting first with the 2007 return.

*** Indicates a surplus.

Pew's Cost Neutral Cash Balance Plan



- ▶ The Cost Neutral Cash Balance Plan proposed by Pew includes an excess gain sharing provision similar to the one used in the API Model.
- ▶ As in the API plan, this provision may **increase** the risk of future unfunded liabilities as compared to the risk in Tier II.

Alternative Plan Conclusions



- ▶ Lowering the risk of future unfunded liabilities for employers will require paying a higher normal cost than is required under Tier II or paying lower benefits to members.
- ▶ There does not appear to be an alternative plan design that lowers the normal cost, lowers risk, and provides a similar benefit to Tier II.



Questions?