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To: **Chairmen and Members of the Joint Committee on Alabama Public Pensions**  
From: **The Pew Charitable Trusts**  
Re: **Summary of Findings and Considerations**  
Date: **January 13, 2016**

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The Pew Charitable Trusts was named as a resource for research and analysis for the Joint Committee on Alabama Public Pensions (JCAPP) in the resolution establishing the Committee and Pew’s review of Alabama’s retirement policies has been ongoing since the Committee’s formation in June, 2015. The following report summarizes our findings and considerations to help inform the Committee’s deliberations and recommendations to the legislature.

Alabama’s annual pension costs have doubled since 2003 and the state’s pension funds have just two-thirds of the actuarially recommended assets. Furthermore, the \$11 billion unfunded liability for retiree health benefits is almost as large as the state’s pension debt. Workers and retirees depend on the retirement systems being fiscally sound to enable them to receive their promised benefits. The Committee’s review of Alabama retirement policies will need to consider the policy goals of both retirement security and fiscal sustainability in issuing its recommendations to the legislature.

The report below describes our findings on funding, investments, governance, and benefits, as well as answering specific questions posed by the Committee and stakeholders. Responses to Committee Member questions not answered in the body of the report are contained in Appendix A.

## PENSION FUNDING

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### Summary

The pension benefits provided through the Retirement Systems of Alabama were just 67 percent funded as of 2014, below the national average of 72 percent<sup>1</sup>, and with a total unfunded liability of over \$15 billion. Our analysis reviewed the historical sources of the unfunded liability, the state's policy for making annual required contribution (ARC) payments into the plans each year based on actuarial calculations, and a projection of how the pension debt is expected to be paid down over time. As funding levels declined, employer contributions were increased in response, along with an increase in employee contributions in 2011. Furthermore, even though Alabama and local employers have paid their full actuarial bill each and every year, the state's funding level has declined compared to other states due to a contribution policy that has not been sufficient to pay down pension debt, and other factors.

These funding challenges will have long-term fiscal consequences to the state—actual costs are estimated to be around 10 percent of payroll for the next 30 years even as the stated costs of new benefits are around 1 percent of pay. These increased costs will still be insufficient to fully fund the pension plan before 2050 (the RSA's actuary projects 2057). These projections assume investments perform at the targeted rate of return and do not yet account for the impact on the unfunded liability associated with 2015 returns. A projection of costs under various investment scenarios shows that if returns are better than expected employer pension costs will be lower but under a low investment scenario annual state and local contributions could reach \$5 billion.

### Historic Drivers of Alabama's Pension Debt

In 2001 Alabama's pension benefits were fully funded. In subsequent years, funding levels dropped as liabilities grew faster than assets despite the state making the full actuarial contribution each year. The rapid growth of Alabama's pension debt has three main causes: (1) investment performance that fell short of assumptions, (2) a contribution policy that has not been sufficient to reduce pension debt, and (3) benefit increases that were not funded.

An analysis of the actuarial reports for the state employees and teachers found a more than \$13.5 billion swing from a surplus to unfunded liability from 2000 through 2014<sup>2</sup>. Of that, the majority of losses were due to investment underperformance—a decline of nearly \$10 billion in the fund balance. A contribution policy that allowed existing unfunded liabilities to keep growing added approximately \$5 billion more in pension debt—even though the state and local employer paid the full actuarial contribution each year.<sup>3</sup> Finally, cost of living increases that were offered without any

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<sup>1</sup> National average as of 2013, the latest year for which 50-state data is available; 2014 average is expected to rise slightly.

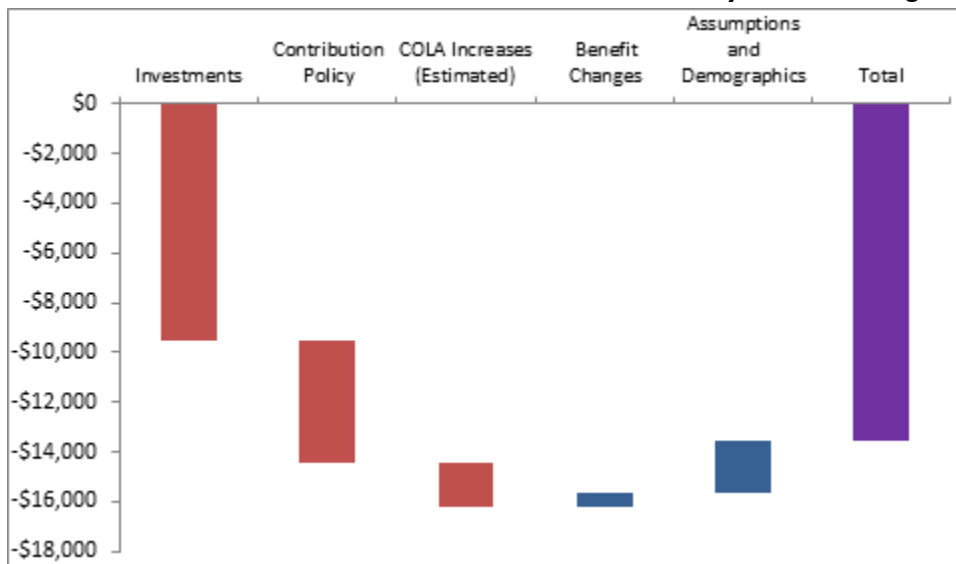
<sup>2</sup> Detailed data on the local pensions provided through RSA are not available.

<sup>3</sup> Government accounting standards allowed actuarial contribution policies with the following attributes: long payment periods (up to 30 years), backloaded (contributions grow over time), and open (contribution policy resets each year). As a result, contributions were insufficient to pay down interest.

additional funding increased liabilities by approximately \$1.8 billion over the period. These drivers are depicted by the red bars in the chart below.

The blue bars in the chart below depict factors that contributed to the decline in the pension debt during this period. Pension changes in 2011 and 2012 reduced the unfunded liability by close to \$550 million as well as reducing benefits for new workers. The immediate impact was due to an increase in current employee contribution rates from 5% to 7.5% of pay—this actually led to a drop in employer contributions for 2012 with employees picking up the difference. Additional demographic factors and actuarial assumption changes added up to a more than \$2 billion decline in estimated pension debt.

**Sources of Growth in Alabama Unfunded Pension Liability, 2001 through 2014**

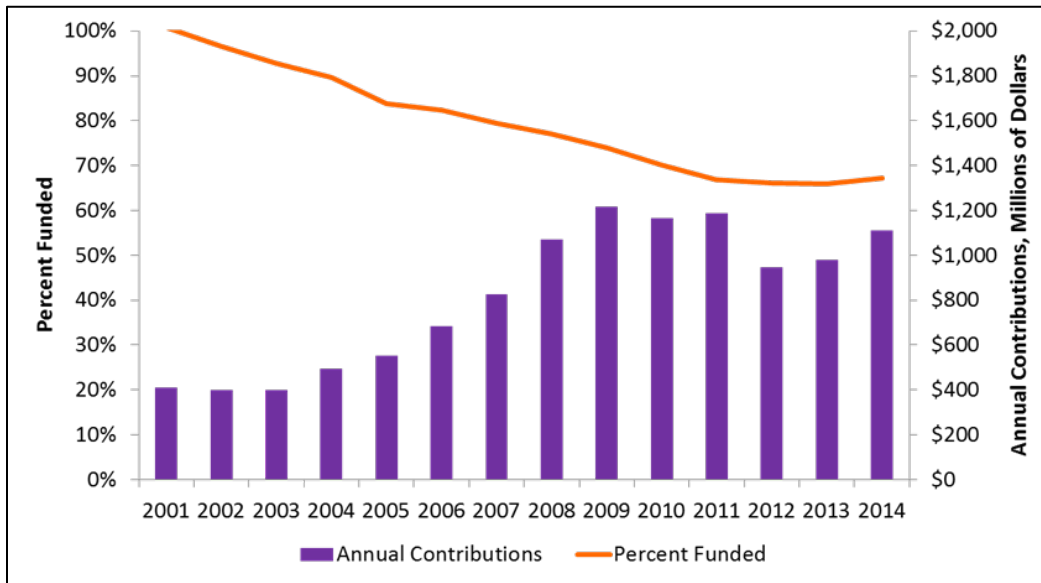


Source: Review of Retirement System of Alabama actuarial valuations.

Further changes were made that mitigate two of the sources of growth in the unfunded liability. In 2013 RSA began phasing in a funding plan that over the long-term will start to pay down pension debt. Policymakers have also recognized that unfunded COLAs are fiscally unsustainable; the last were issued in 2005 and 2006.

Decreased funding levels led to increased employer contributions, which grew 8% annually from 2001 through 2014. That growth rate includes a drop in employer contributions in 2012 due to pension changes—costs returned to an upward trajectory, which is projected to last through 2044.

**Alabama Pension Funding and Contributions**



Source: Review of RSA actuarial valuations and financial reports.

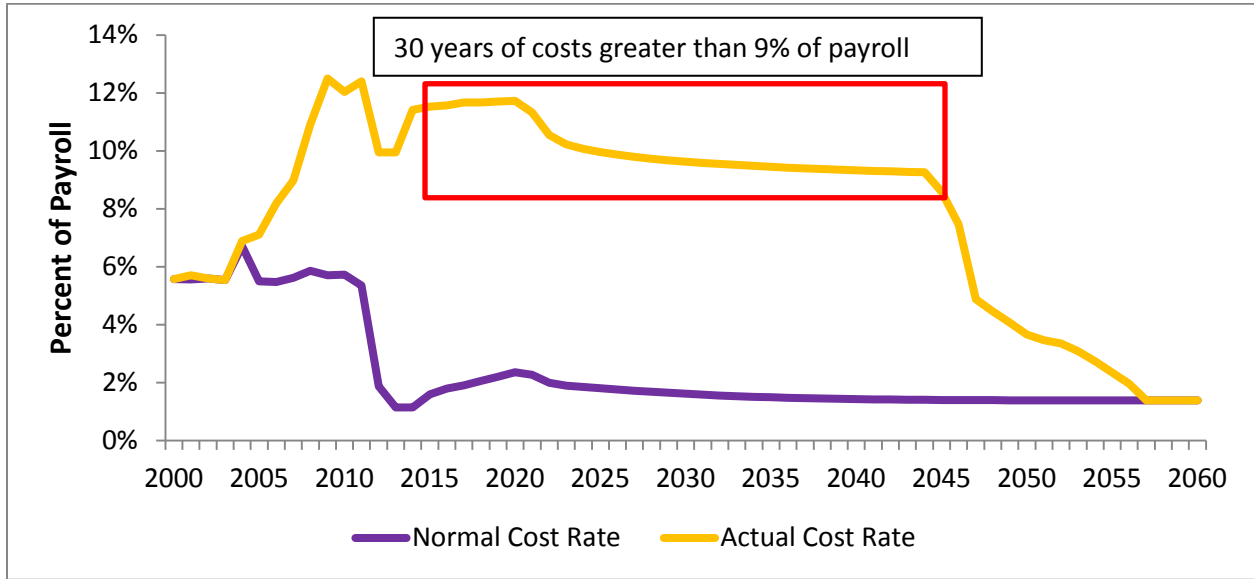
The decline in employer contributions from 2011 to 2012 is unusual—Alabama is one of just 6 states to have a reduction in actuarial required contribution from 2008 to 2013 as a result of a pension change. In Alabama’s case, this was due to the change in the employee contribution rate—employees were made responsible for an increased share of retirement costs. Other states, including New Mexico and Ohio, have also increased contributions for current plan members as a way of sharing risk on an ad-hoc basis.

**Projections of Cost and Funding Level**

*Expected/Normal Cost vs. Actual Cost*

Alabama’s expected cost for a new worker’s benefits in 2014 was estimated to be approximately 1.1% of payroll. In other words, if existing liabilities were fully funded and actuarial assumptions (including the 8% investment return assumption) were met going forward, the cost of paying for pensions would be 1.1% of payroll. That expected cost is also referred to as the normal cost. However, *actual* costs in 2014 were about 11% of payroll, 10 times the normal cost. Actual costs have been higher than the normal cost since 2005 and are projected to continue to be significantly higher than normal cost through at least 2045.

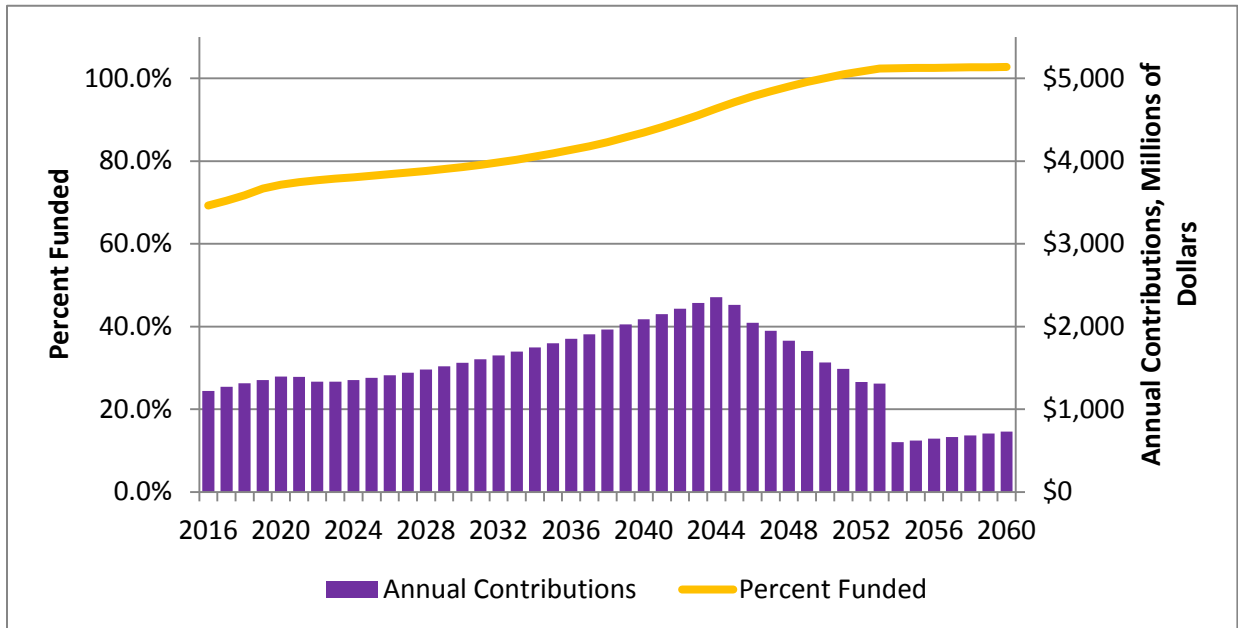
**Projected Normal Cost vs. Actual Cost for Alabama Pensions**



Source: Analysis by Pew and The Terry Group

These increased costs will pay down pension debt over time but it will take decades. Costs will continue to rise and are expected to peak in 2044 before beginning to decline. Meanwhile funding is projected to improve but not hit 100% until 2050 or later. The long-lag until full funding is due to the 15 year phase-in of the 2013 policy change to improve funding policy. In an effort to reduce the short-term budget impact of the policy change, only 1/15<sup>th</sup> of the unfunded liability is subject to the improved contribution standard each year, meaning that it will take 15 years for the new contribution policy to be in full effect. This makes the short-term budget situation more manageable but pushes out costs over the long-run.

**Projected Funding and Contributions, Alabama Pensions at 8% Returns**



Source: Analysis by Pew and The Terry Group

### **Stress Testing**

The cost projections above show what would happen if actuarial assumptions are all met. However, the prudent management of a pension fund takes account for the fact that investment returns and therefore costs are uncertain; and that planning for alternative scenarios is important.

Stress testing investment return assumptions to estimate the impact on costs to taxpayers under different scenarios helps policymakers to better understand and plan for the fiscal risks built into the retirement policies. The Society of Actuaries (SOA) commissioned a Blue Ribbon Panel report<sup>4</sup> that identified stress tests as a best practice and new Government Accounting Standards Board rules (GASB 68) require limited stress tests in certain plan documents.

Building on the SOA recommendations and GASB rules, an example stress test policy would require the board provide that the plan actuary shall annually conduct a test of the ability of the plan to withstand a period of investment returns above or below the level of assumed return by measuring the effect of investment returns over a 10 and 20 year period that are 1.5 and 3 percentage points below the assumed return investments on projected employer contributions. Policymakers should additionally consider an upside scenario where returns are higher than expected. Alternative investment scenarios should also be applied to the cost analysis for changes in retirement policy. We also recommend that this enhanced reporting include a calculation of the projected change, or amortization, in pension debt under current policy over a 10 to 20 year period.

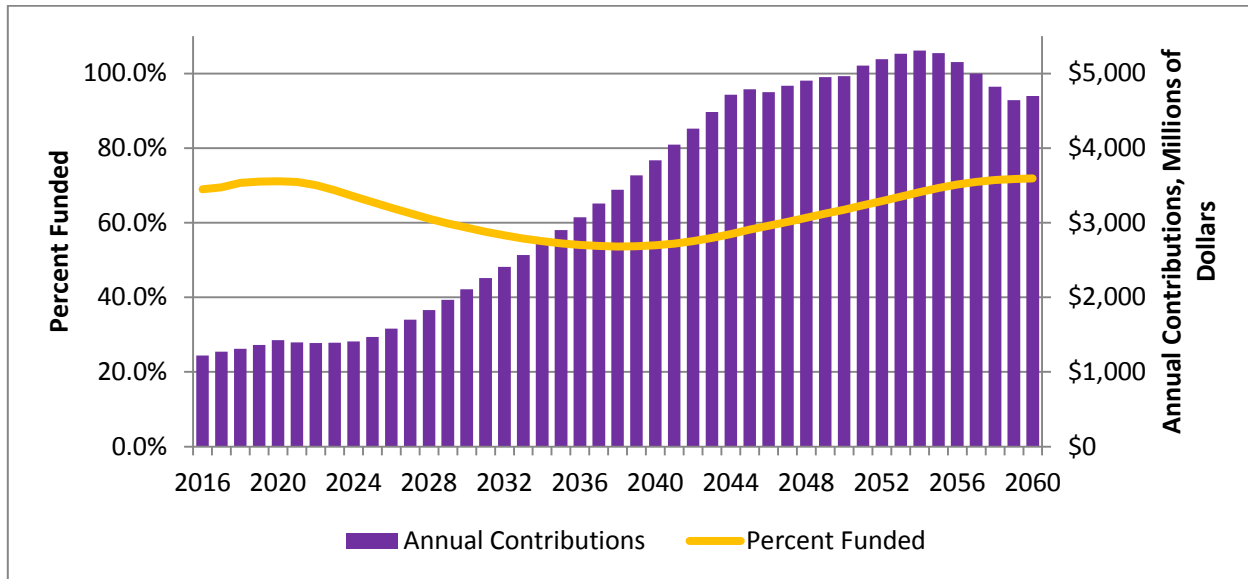
The following analysis includes total contributions for the Employees' Retirement System and Teachers' Retirement System based on projections, taking the 8% return scenario as a starting point and then evaluating a downside and an upside scenario as well.

The downside scenario of 6.25% is estimated to be the 25<sup>th</sup> percentile scenario—if a reasonable best guess of future returns is 8% and investments follow normal variance, then over the next 30 years there is a 25% chance that returns will be 6.25% or lower. The upside scenario of 9.9% is estimated to be the 75<sup>th</sup> percentile scenario—if 8% is the best guess of future returns then there is a 25% chance that future returns over the next 30 years will be 9.9% or higher. Note that all these scenarios are based on 8% as the best estimate of long-term returns, if the true path of future returns is closer to 7% or 9% then the scenarios would be different.

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<sup>4</sup> <https://www.soa.org/blueribbonpanel/>

**Projected Funding and Contributions, Alabama Pensions at 6.25% Returns**



Source: Analysis by Pew and The Terry Group

The expected scenario has contributions rise until reaching over \$2.3 billion annually in 2044. The upside scenario has costs declining over time and dropping as the plan develops a significant surplus around 2038. The downside scenario has costs continue to rise as investments fall short, reaching almost \$5 billion in annual costs in 2044. These are long-term projections and are driven by assumptions on investment returns—in reality policymakers would make policy adjustments if returns fell short over time or exceeded expectations. The purpose of this analysis is to make clear that investment gains or losses compared to the current 8% target will have a major fiscal impact on the plan and thus a major fiscal impact on the state and participating local employers. That could result in a scenario where employers are responsible for a \$5 billion pension payment in one year alone.

Public pensions have pushed Alabama’s costs higher than expected for a decade while funding levels dropped. The source of the unfunded liability includes investment risk and return shortfalls as well as policy choices regarding contributions and COLAs. Addressing the current unfunded liability will require decades of increased payments. Even if things go exactly as planned, it will be more than 30 years under current policy until the unfunded liability is fully paid off. If returns are below the 8% target, then costs could be much higher and the pension debt could continue to grow.

**Considerations**

- 1. Adopt a policy to regularly provide stakeholders with stress test analysis that projects plan costs under different economic and investment return scenarios:** Projected pension costs are based on a number of actuarial and investment return assumptions. Stress testing can help policymakers better understand and plan for cost uncertainty if assumptions are not met. This recommendation is informed by our analysis of the historical causes of the unfunded pension liability and consistent with recent recommendations by the Society of Actuaries Blue Ribbon Panel on pension funding. It also builds on new government accounting rules that require limited stress tests in certain plan documents. Alternative investment scenarios should also be applied to

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the cost analysis for changes in retirement policy. We also recommend that this enhanced reporting include a calculation of the projected change, or amortization, in pension debt under current policy over a 10 to 20 year period.

2. **Consider shortening phase-in of contribution policy:** The contribution policy adopted in 2013 will take 15 years to fully go into effect. As a result, pension debt will not be paid off in full until at least 2050. Shortening or eliminating the phase-in period would increase costs in the short-run but reduce costs in the long-run and speed up full funding. Pew's analysis found that eliminating the remaining phase-in would cost an extra \$600 million total through 2030 but save \$1.6 billion from 2030 to 2060 for a net savings of \$1 billion. Costs and savings are adjusted for inflation.
3. **Require actuarial funding of benefit increases:** To ensure pension benefits are fiscally sustainable, any future increase in benefits, including Cost of Living Adjustments, should require an appropriation to pay for any increase in the unfunded liability.



## INVESTMENTS

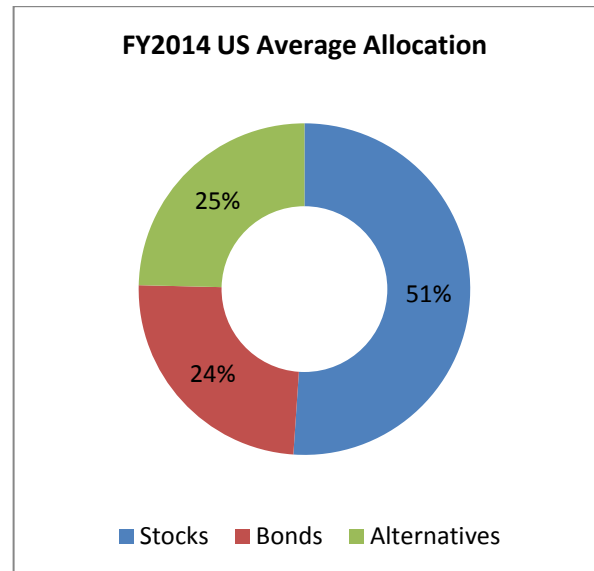
The analysis of the RSA investment program centered on review of three characteristics: allocation of the system’s assets, investment performance as measured by rates of return over 10 to 20 years, and the cost of managing the program. Data on each of these characteristics were collected from RSA comprehensive annual financial reports (CAFRs), State Street Investment reports provided by RSA, and other reports found on the RSA web site. Metrics for RSA were then assessed using Pew’s 50-state research on public pension systems as well as industry-wide benchmarks reported both by Wilshire TUCS and State Street in their RSA-specific reporting.

### Asset Allocation Overview

The ERS and TRS investments total \$33 billion as of 2014 reporting, with 14% in bonds, 64% in stocks, and the balance in real estate, private equity and private placement investments, including 16% of assets in RSA-identified in-state, investments. The charts below compare RSA’s asset allocation with that of the average US state pension.

**2014 RSA Asset Allocation**

<b>Equity</b>	<b>66.1%</b>
Public Equity	63.8%
Private Equity	2.3%
<b>Fixed Income</b>	<b>24.5%</b>
Private Placements -- Raycom	7.6%
Private Placements -- Other	2.9%
Other Fixed Income	14.0%
<b>Real Estate</b>	<b>9.4%</b>
In-State	4.8%
Other	4.6%



Source: State Street Investment Analytics Summary of Performance ending September 30, 2014, as provided by RSA; and data collected from 73 public plan CAFRs and Investment Reports.

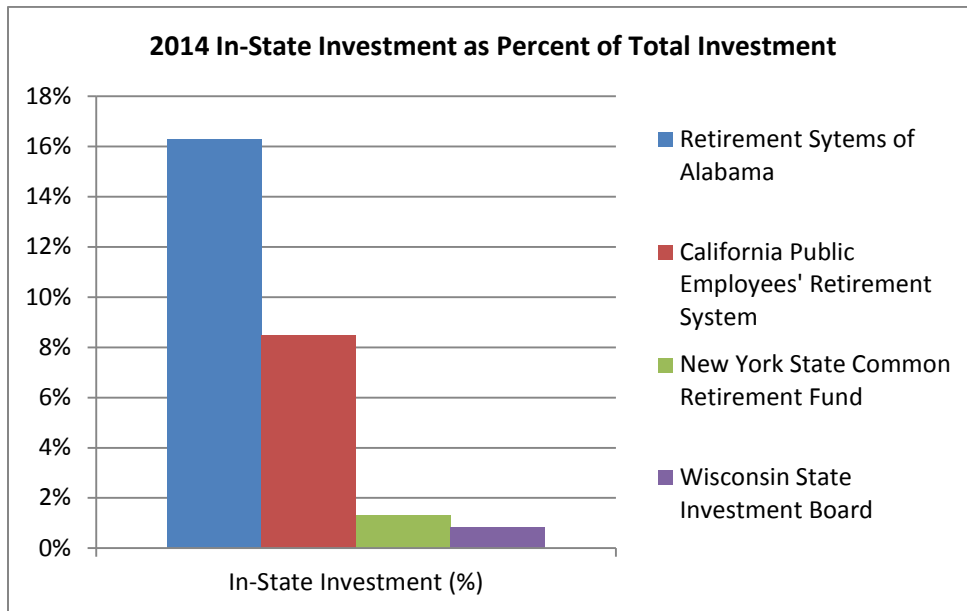
RSA has emphasized that the fund’s exposure to equity investments, when combining publicly traded stocks and private equity, is similar to other public funds when combining these two asset classes. RSA has also noted that the private placement investments, which are structured as loans to privately held companies, are not directly comparable from a performance perspective to alternative investments like private equity and hedge funds that other public funds use. The plan has also emphasized that these alternative investments used by other funds carry much higher fees.

### High Allocation to Economically-Targeted Investments

Alabama’s retirement system has a significant allocation to economically targeted investments (ETI) – defined as investments that have been selected for their economic or social benefits in addition to the

investment return to the employee benefit plan. These investments are also referred to as in-state investments in RSA publications and commissioned reports.

Approximately 16 percent of the RSA portfolio was invested in ETIs at the end of fiscal year 2014, including 4.8 percent in Alabama real estate and 11.5 percent in private equity or private placement investments with Alabama-headquartered businesses. All Alabama ETIs were verified as in-state, economically-targeted investments using the May 2012 RSA-commissioned report “2009-2011 Economic Impacts of FSA on Alabama,” provided on the RSA website.



Source: State Street Investment Analytics Summary of Performance ending September 30, 2014, as provided by RSA; CalPERS for California Annual Report 2014; Investing in New York State, September 2014; and State of Wisconsin Investment Board.

This is arguably the largest ETI allocation in the country. Pension programs that report public data on their ETI programs include California Public Employees' Retirement System or CalPERS (reporting 8.5 percent of assets including investments in publicly traded equities for companies with headquarters in the state), New York State Common Retirement Fund (with 1.3 percent of assets in-state) and Wisconsin State Investment Board (with 0.8 percent of assets in-state). Further, many states set statutory limits on ETI programs, ranging from 2-3 percent of assets (e.g., in Florida and Montana) to as high as 10 percent of assets in Arkansas. Note that the proportion of in-state investments for CalPERS is mainly driven by the size and volume of business activity in the state.

### Performance Overview

Pew analysis reveals that RSA investments have underperformed relative to the RSA assumed rate of return as well as the State Street and Wilshire TUCS public funds benchmarks over the 10- and 20-year time horizons. Returns are reported gross of fees by both RSA and TUCS; however, Alabama's reported fees and expenses are low, at less than 5 basis points (bps), relative to the estimated 30 to 50 bps average fees reported by pension funds nationwide. Even so, the Alabama returns are still

well below the median after making reasonable adjustments for fees to the State Street and TUCS benchmarks.

**Ten-Year and Twenty Year Returns as of September 30, 2014**

	10-Year Gross of Fees	20-Year Gross of Fees
TRS	6.43%	7.51%
ERS	6.15%	7.32%
Total RSA	6.32%	7.43%
<b>State Street Median</b>		
	7.28%	
<b>TUCS Median</b>		
	7.35%	8.48%
<b>State Street 75th Percentile (bottom quartile)</b>		
	6.71%	
<b>TUCS 75<sup>th</sup> Percentile (bottom quartile)</b>		
	6.87%	8.06%

Source: State Street Investment Analytics Summary of Performance ending September 30, 2014, as provided by RSA; Wilshire TUCS.

RSA has noted that returns in recent years have been stronger, particularly in the 1- to 5-year time horizon. Exhibit 5 below summarizes the RSA performance over this shorter time horizon, which is well within the top quartile.

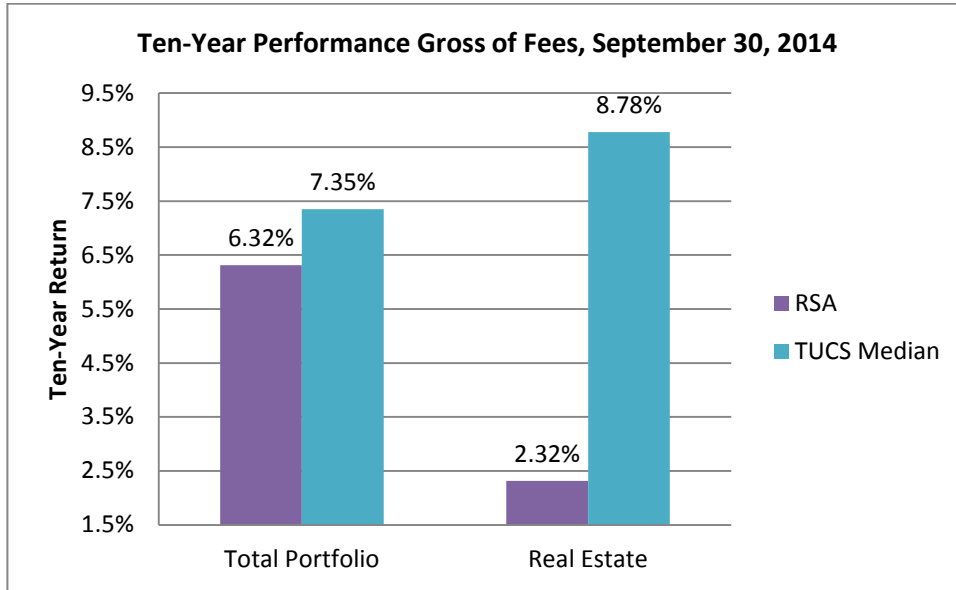
**Reported Returns as of September 30, 2014**

	1-Year	3-Year	5-Year
TRS	12.13%	15.09%	10.97%
ERS	12.02%	14.85%	10.93%
TOTAL RSA	12.09%	14.99%	10.95%
<b>State Street Top Quartile</b>			
	11.34%	14.43%	10.95%
<b>State Street Median</b>			
	10.67%	13.06%	10.38%

Source: State Street Investment Analytics Summary of Performance ending September 30, 2014, as provided by RSA.

**Long-Term Underperformance Driven Largely by the Real Estate Portfolio**

Further analysis of RSA’s long-term underperformance reveals that it is driven in part by underperformance in alternative investments and in particular the real estate portfolio. Although we do not have access to 20-year performance data by asset class for the RSA plans, the chart below illustrates 10-year returns on a gross-of-fee basis for both RSA and the Wilshire TUCS Median.



Source: State Street Investment Analytics Summary of Performance ending September 30, 2014, as provided by RSA; Wilshire TUCS.

Given the portfolio allocation to real estate, this result essentially explains the overall under-performance of the fund. RSA has made the point that certain of the real estate investments were made in development projects, including office buildings and resort properties, that take a number of years to generate income and were made based on longer time horizons.

**Fees among the Lowest in the Country**

The RSA has some of the lowest reported fees in the country due to the internal management of investments and the use of direct investments rather than high-fee external funds or limited partnerships to implement the alternative investment program. As noted above, RSA reports fees of about 5 basis points annually. This is in marked contrast to average fees of 30 to 50 basis points nation-wide and is a direct result of the internal management practices of RSA, which has eschewed high-fee investment vehicles such as hedge funds and limited partnerships. States that invest heavily in these types of investments can experience fees well in excess of the national average. For example, South Carolina Retirement Systems, which holds nearly 40 percent of its assets in alternative investments, reported \$468 million in investment expenses in 2014, or 156 basis points for the fund.

**Transparency**

Our transparency recommendations, based on a 50-state analysis of the reporting practices of public pension funds, are provided in the table below along with the current RSA reporting practices. Policymakers, stakeholders, and the public need full disclosure on investment performance and fees to ensure that risks, returns, and costs are balanced in ways that follow best practices and meet funds’ policy needs. While there is no one-size-fits-all approach to investing pension assets, our research indicates that reporting standards have not kept pace with the increasing risk and complexity in public pension funds. For example, many funds report investment performance before deducting fees paid to asset managers. And research indicates that fully half of the fees charged

against private equity investments, including carried interest performance bonuses, are not included in public fund disclosures. This affords Alabama to assert itself as a leader on public pension investment disclosure.

As noted, many of Alabama’s current practices are already in line with our recommendations. For example, RSA’s investment policy statements are easily accessible, and performance is reported for several asset classes. However, better disclosure rules would help those with a stake in the retirement system discern how well investments are being managed and provide data that could be compared more easily from state to state and on a longer-term time horizon. For example, reporting returns net of fees in addition to the current practice of reporting gross of fees in Alabama would not only provide a more accurate measure of performance but would also highlight the low RSA fee levels. Similarly, although our recommendations regarding the ILPA fee reporting standards has limited application in Alabama given RSA’s in-house investment management, employing those standards that do apply would highlight low fees relative to other funds.

**Alabama Investment Transparency Compared to Recommendations**

Recommendation	Alabama Status
<b>Make investment policy statements transparent and accessible</b>	Alabama provides investment policy statements on-line.
<b>Disclose bottom line performance both net and gross of fees.</b>	Alabama reports performance gross of fees. Including net of fees reporting would provide bottom line results and highlight the fact that RSA’s reported fees are among the lowest in the country.
<b>Report results by asset class (gross and net of fees)</b>	Alabama reports performance gross of fees for domestic equities, international equities, and the sum of fixed income plus alternative investments. Performance should be reported for all asset classes, including separate reporting for fixed income, private placements, private equity and real estate.
<b>Expand reporting to include performance over 20+ years (gross and net of fees and by asset class) to align with long-term nature of pension liabilities.</b>	Alabama reports results for 1-, 3-, 5-, and 10-year time horizons, consistent with most common practices. Longer term results have been included in supplemental reports and could be added to annual disclosure.
<b>Adopt comprehensive fee-reporting standards, such as those proposed by the Institutional Limited Partnership Association’s Fee Transparency Initiative.</b>	Alabama manages investments in-house, with lower levels of external fees to report. Review of ILPA standards and further disclosure on ownership levels of in-state investments offers opportunity to raise the bar on transparency.

### **Considerations**

1. **Improve transparency in pension investment reporting:** Alabama meets required standards of disclosure and reporting. Recommended improvements that would make Alabama an industry-wide leader in reporting practices include:
  - a. Providing performance figures on a net-of-fee basis in addition to current gross-of-fee reporting.
  - b. Extending reporting time horizons for performance to include the 20-years or more.
  - c. Reporting performance (net- and gross-of-fees) for all asset classes, including separate reporting for fixed income, private placements, private equity and real estate.
  - d. Adopting reporting standards for private equity fee reporting as proposed by the Institutional Limited Partnership Association.

## CURRENT PENSION BENEFITS

Current public workers in Alabama receive a final average salary defined benefit (DB) and have access to additional defined contribution (DC) accounts as an optional retirement supplement. The DB benefit provides guaranteed lifetime income using a formula based on a multiplier, years of service, and final average salary. This design is the most common type of plan provided to state and local public workers. The optional DC accounts are similar to a 401(k) plan.

Workers who entered public service prior to 2013 receive a benefit based on a multiplier of 2.0125%, slightly above the 2% most common in public plan, pay an employee contribution rate of 7.5%, and are required to work 10 years to qualify for the benefit. Both the employee contribution rate and vesting period are above the median found in state plans. Public employees hired on or after January 1, 2013 have a reduced multiplier of 1.65%, a lower contribution rate of 6%, and higher retirement age requirements. Public safety workers have similar benefits with an earlier eligible retirement age. The benefit does not include a guaranteed cost of living adjustment (COLA), but in prior years COLAs were granted by the legislature.

### Alabama DB plan in a national context

State/Local/Teachers	Tier 1 (hired before January 1, 2013)	Tier 2 (hired on or after January 1, 2013)	Comparison to Plans for New Employees in Other States
<b>Multiplier</b>	2.0125%	1.65%	The average general employee plan multiplier is between 1.8 % and 1.9%.
<b>COLA</b>	Ad hoc	Ad hoc	60 to 70% of State/Local/Teacher plans offer a COLA, while the remainder had ad hoc COLAs or no COLAs.
<b>Employee Contribution</b>	7.50%	6%	The average contribution rate for a new state and local employees was 5% and 6% for teachers.
<b>Vesting</b>	10 years	10 years	Average vesting period for new teachers, state, and local employees is 6 to 7 years. More plans had a 5 year vesting than a 10 year vesting period.
<b>Normal Retirement</b>	60/10, Any/25	62/10	For new hires, the average earliest retirement age for teachers and state employees with 20 or fewer years of service was 63 to 64.

Source: The Urban Institute's State and Local Employee Pension Database.

Note: The Alabama DB plan provides relatively low interest on employee contributions withdrawn by members. Tier 2 members with less than three years of service receive no interest on their withdrawn

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contributions if they leave prior to retirement, workers with 3 to 16 years of service receive only 2% interest, and workers with more than 16 years receive between 2 and 3%.<sup>5</sup>

Workers can also contribute to two supplemental defined contribution plans—RSA-1 and the Alabama Deferred Compensation Plan—to build up additional retirement savings. About 12% of state workers, 7% of local employees, and 8% of teachers choose to contribute to RSA-1 with typical contributions of 4 to 6% of salary. Approximately 30% of eligible state workers participate in the Alabama Deferred Compensation Plan, with an average contribution of 2.2% of salary. Local employees are also eligible to participate to the deferred compensation plan.

In our previous analysis Pew highlighted that a substantial percentage of the assets in both plans are invested in fixed income options— 66% for RSA-1 and 50% for the Deferred Compensation Plan. Pew does not argue against workers investing a portion of their retirement savings in safer assets or making investment decisions that reflect their tolerance for risk. However, research demonstrates that most individuals lack the expertise necessary to make good investment decisions on their own and that offering a limited number of low-fee investment options leads to the best outcomes.<sup>6</sup> As a result, Pew’s considerations include adding target date or life cycle funds to the RSA-1 options with a mix of assets based on workers’ expected age at retirement. These funds could be designed by leveraging RSA’s in-house investment expertise and reviewing the fund options under the Deferred Compensation Plan.

Experts typically assess retirement security based on the level of savings and expected replacement income from three sources: employer provided benefits, Social Security, and individual savings. The current plan provides a significant level of benefit for career workers – with 35 years of service, for example, workers would receive social security plus a pension benefit equal to 54% of career ending salary at retirement.

However, the majority of public workers leave before becoming vested in the system. Retirement savings for younger and mid-career workers who change jobs are limited by three factors: the 10 year vesting period, the fact that workers who withdraw their contributions upon separation only receive their employee contributions at a low rate of interest, and the relatively low participation rates in the supplemental DC plans.

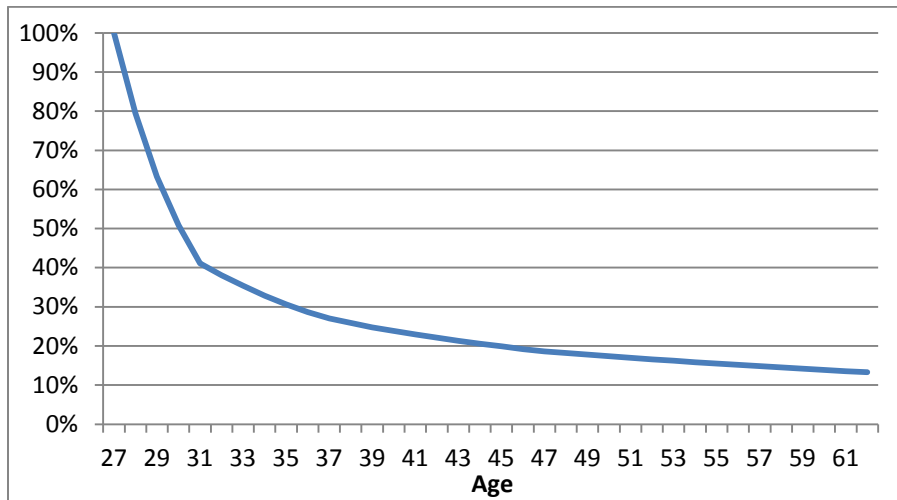
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<sup>5</sup> 2013 Alabama Employee Retirement System Tier 2 Member Handbook, p. 9

<sup>6</sup> Annamaria Lusardi and Olivia S. Mitchell, “Financial Literacy and Retirement Planning: New Evidence from the Rand American Live Panel,” 2007. Shlomo Benartzi and Richard H. Thaler, “Naïve Diversification Strategies in Defined Contribution Saving Plans,” *The American Economic Review*, Vol 19, N. 1 (Mar., 2001).; Jeffrey R. Brown, Nellie Liang, and Scott Weisbenner, “Individual account investment options and portfolio choice: Behavioral lessons from 401(k) plans,” *Journal of Public Economics*, Volume 91, Issue 10, November 2007.; Susan Stabile, “The Behavior of Defined Contribution Plan Participants,” *New York University Law Review* (2002). ; Julie Agnew and Lisa Szykman, “Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice and Investor Experience,” *Center for Retirement Research, Boston College*, (2004). ; James J. Choi, David Laibson, and Brigitte C. Madrian, Andrew Metrick, “Reinforcement Learning and Savings Behavior,” *Journal of Finance* (2009). ; James J. Choi, David Laibson, and Brigitte C. Madrian, “Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds,” *Review of Finance Studies* (2010).



**Attrition among State Workers Starting at Age 27—Fewer than 30% of Public Employees in Alabama are expected to stay until the 10 year vesting requirement.**



Source: Withdrawal assumptions for male and female state and local workers taken from ERS actuarial valuation. Chart assumes 50/50 gender split.

Given this, Pew recommends the following design consideration for the two optional DC plans in order to improve retirement security for all workers without imposing additional costs on the state. Providing participants with a limited set of low-fee investment options with appropriate asset allocations, including a default target date fund, helps reduce likelihood of participants selecting the incorrect level of risk for their expected retirement and leads to the best outcomes for DC plan participants.<sup>7</sup>

**Considerations**

- 1. Provide a life-cycle or target date fund through RSA-1:** The investment options in RSA-1 meet two key best practices—a limited number of options with low-fees. By incorporating a third best practice, including a life-cycle or target date fund, individual workers can benefit from the investment expertise of RSA staff and/or external investment managers and will not have to balance and rebalance their investments between equities and fixed income.
- 2. Implement default contributions and auto-escalation for existing DC plans to increase worker savings:** Our research indicates that many public workers in Alabama may not be saving enough for retirement under current policy. Auto-escalation, automatic enrollment, and default employee contributions are tools that encourage workers to increase their retirement savings

<sup>7</sup> Annamaria Lusardi and Olivia S. Mitchell, “Financial Literacy and Retirement Planning: New Evidence from the Rand American Live Panel,” 2007. Shlomo Benartzi and Richard H. Thaler, “Naïve Diversification Strategies in Defined Contribution Saving Plans,” *The American Economic Review*, Vol 19, N. 1 (Mar., 2001); Jeffrey R. Brown, Nellie Liang, and Scott Weisbenner, “Individual account investment options and portfolio choice: Behavioral lessons from 401(k) plans,” *Journal of Public Economics*, Volume 91, Issue 10, November 2007.; Susan Stabile, “The Behavior of Defined Contribution Plan Participants,” *New York University Law Review* (2002). Roderick B. Crane, Michael Heller, Paul Yakoboski, “Defined Contribution Pension Plans in the Public Sector: A Best Practice Benchmark Analysis,” *TIAA-CREF* (2008); Paula Sanford and Joshua M. Franzel, “The Evolving Role of Defined Contribution Plans in the Public Sector,” Arthur N. Caple Foundation and the National Association of Government Defined Contribution Administrators, (2012).

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while still giving employees the opportunity to opt out of the rate or plan.<sup>8</sup> Automatic enrollment with a default contribution rate of 2% would encourage participation. Auto-escalation, where employee DC contributions increase by a modest amount each year, is another way to help workers save. Setting contribution rates to increase by 0.5% a year until hitting a cap would allow auto-escalation to be built into Alabama DC benefits.

- 3. Consider a review of Alabama Deferred Compensation Plan investment choices and fees:** Best practices in defined contribution plan design include offering a small number of investment options with low fees through the use of index funds. The Alabama Deferred Compensation Plan should consider reviewing the available investments option to make sure none are duplicative and that fees are appropriately low.

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<sup>8</sup> John Beshears, James J. Choi, David Laibson, & Brigitte C. Madrian, "The importance of default options for retirement saving outcomes: Evidence from the United States." In *Social security policy in a changing environment* (pp. 167-195). University of Chicago Press (2009).

## PLAN DESIGN FOR NEW HIRES

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Meetings of the Joint Committee on Alabama Public Pensions (JCAPP) have included discussion about whether the state should continue offering new employees the current defined benefit plan or consider other options. States that have consistently made full pension payments using reasonable assumptions and paid for any benefit increases have been able to maintain well-funded defined benefit plans. In other cases, policymakers have implemented hybrid or cash balance models that are designed to better manage the risk and uncertainty of investment return and actuarial assumptions, and to increase retirement savings for younger and mid-career workers who change jobs. Any well-designed retirement plan, whether defined benefit, defined contribution, or a hybrid, will include the elements necessary to promote retirement security for workers:

- A commitment to fully funding retirement promises.
- A combined benefit and savings rate that helps put workers on the path to a secure retirement.
- Professionally managed, low-fee, pooled investments with appropriate asset allocations.
- Access to lifetime income in the form of annuities.

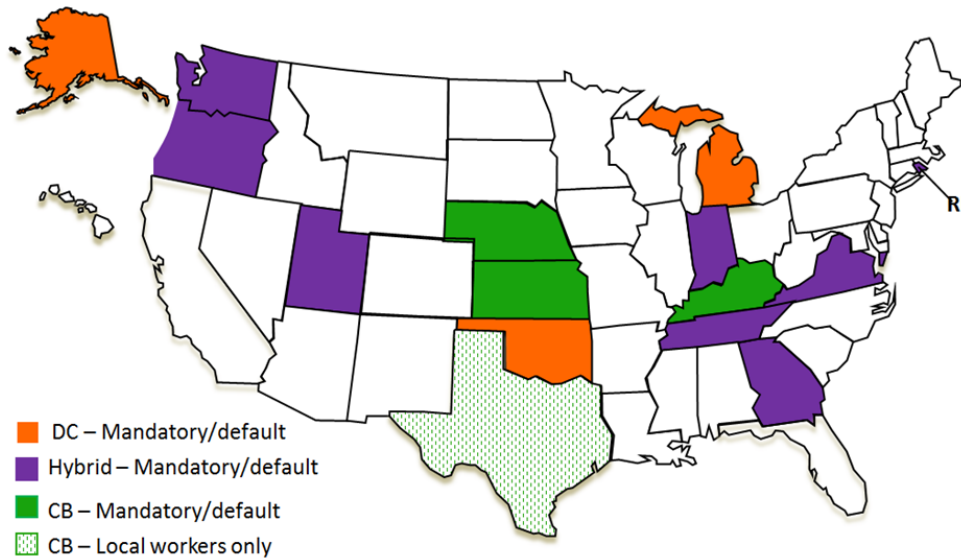
In addition to the analysis contained in this section, Pew also conducted a detailed analysis of a potential cost neutral cash balance plan in response to requests from the Committee and stakeholders. This analysis is summarized in Appendix B.

### **Reforms Across the States**

Pew's analysis of plans across 50 states shows that there is no one-size-fits-all approach to providing retirement benefits for public employees. States have found fiscally sustainable approaches to providing retirement security using defined benefit, defined contribution, and hybrid approaches. Thoughtful plan design balances cost, cost predictability, and retirement security in identifying the best approach given the state's particular goals and needs.

Defined benefit plans similar to Alabama's remain the most common approach in the public sector. However, as the map below depicts, 20 states have implemented an alternative plan for state workers. Fourteen states currently have plans with alternative designs that are mandatory or the default for state workers, while seven states currently have alternative plans that workers may choose as an alternative to the traditional DB plan.

### Alternative Pension Designs Across States



#### Notes:

- 14 states currently have plans with alternative designs that are mandatory or default for at least some state workers.
- In addition, more detailed versions of this table from [NASRA](#) and NCSL make note of optional alternative states plans in the following states: Colorado (DC), Florida (DC), Montana (DC), North Dakota (DC), Ohio (DC and hybrid), and South Carolina (DC).
- In cases where a state has more than one alternative plan, the plan type with the greater number of participants is marked on the map. This includes Indiana where workers choose between a hybrid and DC plan, Michigan where state workers are in a DC plan and teachers are in a hybrid plan, and Utah where workers choose between a hybrid and DC plan
- Texas provides a cash balance plan to over 400,000 local workers and retirees through the state’s Texas Municipal Retirement System and Texas County and District Retirement System.

The two most prevalent hybrid approaches are side-by-side hybrids and cash balance plans. Three states—Alaska, Michigan, and Oklahoma—use a defined contribution plan to provide benefits to new state employees, teachers, or both. The remaining states use hybrid approaches that blend aspects of both a defined benefit and a defined contribution. Side-by-side hybrids are a mandatory or optional benefit in nine states while four states have cash balance plans for state or local workers (California has a small optional cash balance plan for substitute teachers).

While hybrid plans and cash balance plans are new approaches in many states, they do have a track record. Nebraska’s cash balance plan has been in effect since 2003 and Texas’ two cash balance plans for local members were started in 1947 and 1967 respectively. Oregon and Washington have both used a hybrid design for more than a decade.

### **Trade-offs of Hybrid Approaches**

Thoughtful plan design will balance cost, cost predictability, and retirement security. Side-by-side hybrid plans offer a smaller defined benefit and an accompanying defined contribution benefit. The defined benefit has variable costs that the employer will typically cover while the defined contribution typically includes a minimum level of contributions from employees and employer to generate retirement savings. The defined benefit maintains a guaranteed benefit for employees while the defined contribution makes part of the employer costs predictable.

Cash balance plans provide benefits through individual retirement accounts along with two key protections associated with a defined benefit—a guaranteed benefit and lifetime retirement income. Unlike a defined contribution, in a cash balance plan the employer guarantees a minimum interest rate for employee retirement savings. If actual investment returns exceed the minimum guarantee, the worker and the plan typically share the gains. At retirement, workers have to be given the option to convert their benefit into an annuity—a lifetime retirement benefit that never runs out. The plan design allows policymakers to set a minimum interest rate and rules for sharing gains that clearly and transparently manage investment risk.

### **Assessing Alternatives**

At the October meeting of the JCAPP, RSA's actuary presented three alternative plan designs—the Federal government's side-by-side hybrid, Utah's hybrid, and Kentucky's cash balance. The three plans selected would provide an overall greater benefit to Alabama retirees at a higher expected cost with less risk. Applying these plans in Alabama but increasing employee contributions to 6% to match current contribution rates would reduce the difference in costs though anticipated costs would remain higher with the alternative designs.<sup>9</sup>

The level and distribution of benefits is an essential component in any analysis of plan design. The analysis should include a variety of employees to understand the implications for retirement security for career workers as well as young workers and employees who change jobs after 10 to 20 years in public service. A feature of final average salary defined benefit plans is that they offer a relatively low benefit to young workers and employees who change jobs with only five to 15 years of public service. Most of the people joining the state and teaching workforce fall into those categories. Comparing the benefits provided in the plan designs identified by RSA's actuary shows that the benefits in the alternative plan designs are significantly higher for a hypothetical state worker who leaves after 10 or 20 years of service while a worker with 35 years of service would get a comparable benefit under the different approaches.

Policymakers evaluating the plans identified by the RSA actuary would need to balance higher expected costs against increased benefits and lower risk. It would also be possible to design cost neutral variants of a side-by-side hybrid or cash balance plan—those would have a lower expected cost than the ones identified by RSA, provide a lower retirement benefit to workers, and would similarly offer a substantial increase in cost predictability. A request for information on cash balance

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<sup>9</sup> See Pew's presentation at the December 1, 2015 meeting of the JCAPP for detailed analysis of these plans.

plan designs was made by the co-chairs of the JCAPP and additional questions on this design were posed by RSA. In response, Pew conducted a separate analysis on a cost neutral cash balance plan (see Appendix B).

In addition to the alternative plan types reviewed above, some states develop risk-sharing features within their defined benefit plans to share unexpected costs with the employee. These methods include:

**Risk-sharing within Defined Benefit Plans**

Cost sharing mechanism	State example
<b>Split the total cost or the normal cost of the plan between the employer and the employer</b>	Arizona State Retirement System – the employer and the employee each contribute half of the total cost.
<b>Adjust the employee contribution in response to investment returns</b>	Pennsylvania’s State Employees and Public School Employees Retirement Systems – employee contribution can be raised or lowered by 0.5% every three years based on whether investment assumptions are met.
<b>Adjust benefit increases after retirement (COLA or PBI) based on investment returns</b>	Connecticut Teachers – COLA is tied to the Social Security’s cost of living adjustment and capped at either 1%, 3%, or 5% depending on investment returns.
<b>Adjust benefit increases after retirement (COLA or PBI) based on plan funding level</b>	Minnesota Public Employees – COLA ranges from 1% to 2.5% based on plan funding level

**Considerations**

1. **Consider and evaluate new plan design options based on impacts to cost predictability for the state and retirement security for all workers.** This memo includes information on cash balance plans and risk based cost sharing within DB plans. Note that funding is essential regardless of plan design. No new plan design will eliminate the unfunded liability and necessity of consistent actuarial funding.

## RETIREE HEALTH BENEFITS (OPEB)

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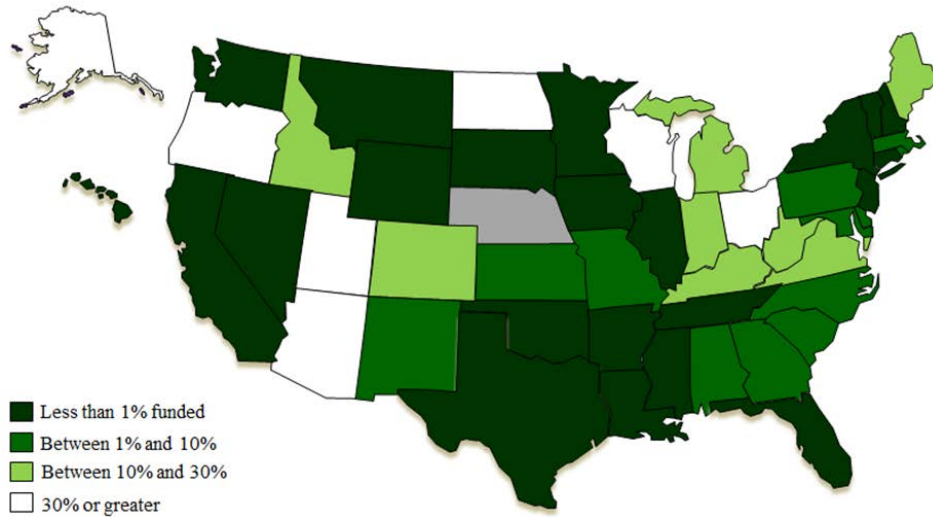
Alabama reported spending \$413 million in 2014 for worker retirement health care benefits other than pensions, which are known as other post-employment benefits (OPEB). The state also reported a total OPEB liability of \$12.6 billion – the cost in today’s dollars of benefits to be paid in future years – with \$1.4 billion or 11% in funding set aside to pay for these commitments. The state pays for a percentage of retiree health care premiums for retired workers and their spouse, where the percentage paid is determined using a formula based on the retirees’ age and years of service with the state. Benefits are administered by the State Employee Health Insurance Plan (SEHIP) and the Public Education Employees’ Health Insurance Plan (PEEHIP). The average employer contribution was reported as \$5,412 for pre-Medicare workers and \$4,152 for Medicare eligible retirees.

Alabama’s OPEB liability and level of benefit is higher than average when compared to other states on both a national and regional level. In prior meetings, we discussed that states with a benefit formula that is tied to a percentage of health care premiums typically have higher OPEB liabilities and costs, while states that provide only a fixed dollar contribution or provide health coverage without a subsidy have lower liabilities. This memo includes a more detailed discussion on the state’s spending for retiree health care, additional comparative data, and more information on steps that other states have taken to manage OPEB liabilities and costs. These analyses do not constitute a specific recommendation, and we note that the state has taken action to manage OPEB liabilities and lower costs in recent years by instituting the formula that bases benefits on years of service and age.

### **OPEB Funding**

In 2013, Alabama’s 10% funded ratio—the percentage of assets set aside to pay for future benefits – was higher than the 50-state average of 6%. Alabama’s funded ratio improved in 2014 to 11% as assets grew faster than liabilities. Prior to 2007, states were not required to measure or disclose retiree health care liabilities and most states managed these benefits solely on a pay-as-you-go basis. Changes to accounting rules revealed that a number of states had accrued substantial actuarial liabilities. As a result some states including Alabama set up trust funds to begin pre-funding these benefits. State retiree health care funding ratios vary widely, from less than 1 percent in 22 states to 73 percent in Arizona in 2013 (the latest available 50 state data).

### Funding of Retiree Health Benefits by States, FY 2013



Source: Pew review of state and retirement plan financial reports and actuarial valuations.

#### OPEB Benefit and Premiums

Retirees with at least 10 years of service receive a benefit that pays a percentage of the premium for retiree health insurance. Benefits are available for both retirees eligible for Medicare and for those who retire before Medicare eligibility, and the state also offers coverage for spouses.

The 2014 actuarial valuations for the teacher and state plans provide information on the health insurance premiums. The tables below show the employee and employer premiums. There are additional adjustments for income, spousal coverage, and wellness plan participation and tobacco use for PEEHIP that can affect these premiums. Additionally, there is a sliding scale for those retired after 2005, detailed below. The PEEHIP and SEHIP premium data are not directly comparable.

Our understanding is that at 25 years of service PEEHIP Medicare eligible individual retirees who are non-smokers receive 97% of premium and those in SEHIP receive 100% of premium. For those who retire before Medicare eligibility, the state's premium varies based on years of service and age.<sup>10</sup> Based on the sliding scale schedule on the PEEHIP website, a pre-Medicare retiree in the teachers plan in FY 2015 who retired before 2012 would receive a 78% subsidy with 25 years of service, and would receive 100% of premium coverage with 40 years of service.<sup>11</sup>

The SEHIP financial statement says: "The State pays a portion of the premium for a retiree who is under 65. For retirees, who retire on or after October 1, 2005 except for disability, the State contribution for retiree health insurance premiums shall be reduced by 2% for each year of service less than 25 and increased by 2% for each year of service over 25. In no case shall the employer

<sup>10</sup> For those retiring after 2012, there is also an adjustment for the difference between the active employee and pre-Medicare rate subsidies.

<sup>11</sup> *Retiree Sliding Scale Premium Rates 2014-2015*, <http://www.rsa-al.gov/index.php/members/peehip/premiums/>.



contribution of the health insurance premium exceed 100% of the total health insurance premium cost for the retiree."<sup>12</sup>

### Annual Employer and Retiree Premiums for Retiree Health Insurance, Teacher Plan

PEEHIP Premium, Annualized	Single Retiree, Pre-Medicare	Family Pre-Medicare	Single Retiree, Medicare Eligible	Family, Medicare Eligible
<b>Total</b>	\$8,880	\$16,416	\$4,080	\$8,724
<b>Retiree Base Premium</b>	\$1,812	\$4,992	\$120	\$1,428
<b>Employer Base Premium</b>	\$7,068	\$11,424	\$3,960	\$7,296
<b>Retiree Share</b>	20%	30%	3%	16%

Based on premiums for the 2015-2016 plan year from the 2014 actuarial valuation and accounting for preliminary estimates for Medicare Part D drug payments. Retiree base premium is prior to any sliding scale adjustments for post-2005 retirees and do not include the tobacco or wellness surcharge.

### Annual Employer and Retiree Premiums for Retiree Health Insurance, State and Local Plan

SEHIP Premium, Annualized	Single Retiree, Pre-Medicare	Family Pre-Medicare	Single Retiree, Medicare Eligible	Family, Medicare Eligible
<b>Total</b>	\$8,916	\$15,780	\$3,048	\$7,356
<b>Retiree Base Premium with Non-Smoker and Wellness Discounts</b>	\$2,832	\$5,976	\$0	\$1,452
<b>Employer Base Premium</b>	\$6,084	\$9,804	\$3,048	\$5,904
<b>Retiree Base Share</b>	32%	38%	0%	20%

Based on premiums from the 2014 AV and data from SEIB. Employee base premium is prior to any sliding scale adjustments for post-2005 retirees.

#### Sliding Scale Provisions

- Retired between 2005 and 2012: If the retiree has less than 25 years of service, the employer pays 2% less per year of service, and the retiree covers the cost. If the retiree has more than 25 years of service, the employer pays 2% more, and the retiree premium is lowered.
- Retired after January 1, 2012 (phasing-in): If retiring before 25 years of service, the employer pays 4% less per year of service, and the retiree covers the cost. The employer

<sup>12</sup> State Employees' Insurance Board Financial Statements, September 30, 2014, page 41, <http://www.alseib.org/PDF/SEIBFinancials.pdf>.

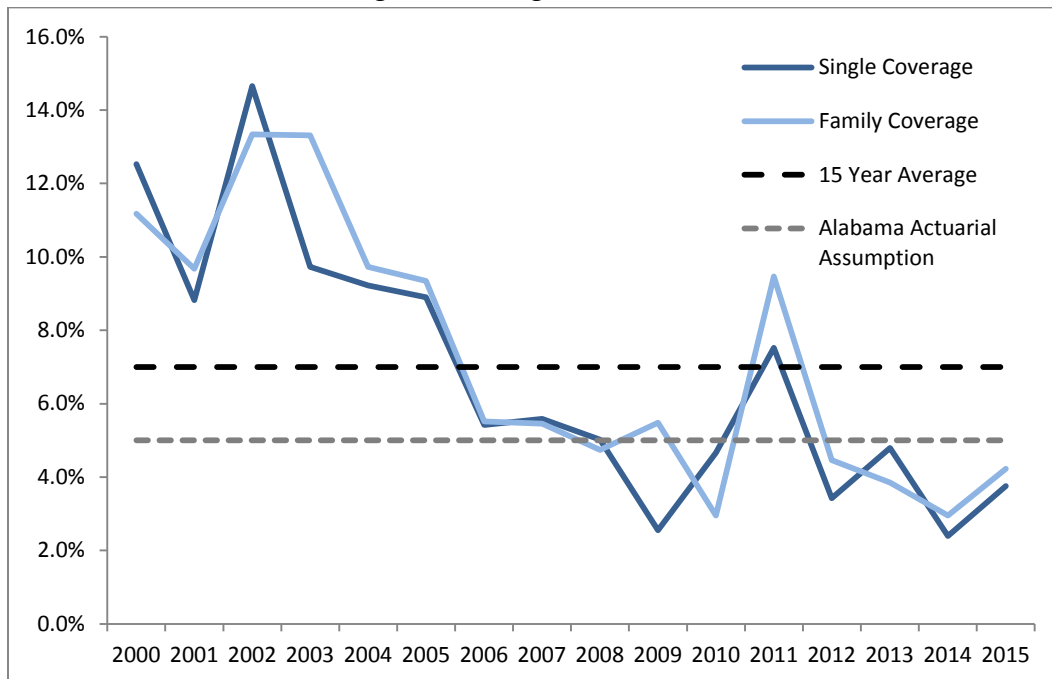
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share still increases by 2% for each year the retiree worked over 25 years. If the retiree is under 65, the employer pays 1% less for each year the retiree is under 65, and the retiree covers the remainder. Once the retiree hits 65, this adjustment no longer applies. For retirees in both plans, the retiree also pays a subsidy premium if under 65 to cover the difference between the subsidy for active employees and the subsidy for pre-Medicare retirees. This is \$147.52 in fiscal year 2016.

While there are multiple drivers to any change in retirement costs, estimated liabilities dropped by \$300 million from 2012 to 2013, after additional benefit changes to retiree health benefits went into effect. Alabama’s retiree health care spending has been relatively stable over the past five years and in 2014 was 5% less than the 2009 employer payment. Three factors have led to this trend—policy changes in 2005 and 2012, greater use of federal Medicare drug dollars through an Employee Group Waiver Plan, and relatively low health care cost growth in recent years.

Long-term retiree health care costs will be shaped by both demographics and per capita health care costs. The actuarial reports indicate an estimated long-term growth rate in health care costs of 5%. If health care cost growth is below that figure, Alabama’s retiree health care liabilities will be lower than estimated. If instead health care inflation is above 5%, Alabama’s costs will be higher than expected. In the United States, health care premiums have gone up on average 7% a year from 2000 for single premiums and for families. More recently health care cost growth has been lower, with 4% growth in premiums from 2012 to 2015. It is unclear whether long-run trends will return to the higher growth of the early 2000s or will stay at the relatively low recent rates.

**Percent Change in Average Annual Premiums, U.S.**



Source: Pew calculations from Kaiser Family Foundation data,  
<https://kaiserfamilyfoundation.files.wordpress.com/2015/08/8775-exhibit-1-111.png>.

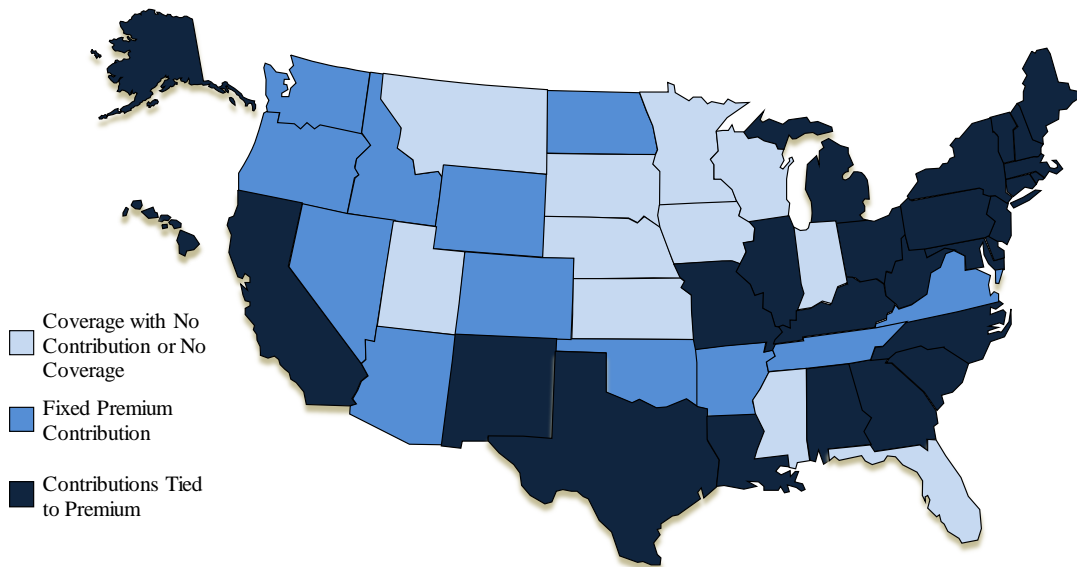
### **Context for OPEB Reforms**

State policymakers across the country have used a number of approaches to manage retiree health care liabilities. Some examples include:

- Increase eligibility requirements: Ohio increased the required years of service to qualify for retiree health care from 10 to 20 starting in December 2014; the state also increased pre-funding efforts.
- Use changes to Medicare drug benefits: New Jersey instituted an Employee Group Waiver Plan (EGWP) for drug benefits to Medicare eligible retirees, reducing expected liabilities by \$11 billion; Louisiana did the same with a reduction of \$2 billion. This change was adopted by 25 other states, including Alabama
- Increase Cost-Sharing: Massachusetts reduced the state premium contribution to 80% from 85% for those who retire after October 1, 2009. Alabama's changes for workers retiring after 2005 and for those retiring after 2012 also fall into this category.
- Change benefit structure: Michigan switched from offering benefits based on a percentage of premium to giving new workers fixed contributions to a health retirement account as well as providing an additional 2% matching contribution on their defined contribution pension benefit.
- Cap cost growth: West Virginia capped annual per-retiree employer cost growth at 3%. If health care inflation is 3% or less, the benefit structure would be unchanged but if health care costs grow faster than 3%, retirees would pay the difference.
- Prefunding: Hawaii, Michigan, and West Virginia recently enacted policies to prefund retiree health obligations.

Across all 50 states Pew's data shows a variety of benefit structures in use. Overall 27 states promise the majority of their retirees a benefit that pays a percentage of retiree health care premiums. As noted, Alabama is in this category which Pew's data shows is overall the most generous way to structure these benefits. 12 states give a fixed subsidy—these benefits typically do not insulate retirees from health care cost growth. Finally, 11 states allow retirees to buy health insurance through their employer with retirees paying the full premium or simply don't provide coverage. States in this category typically charge retirees the same premium as active employees meaning there is a small subsidy built into these benefits.

### Funding of Retiree Health Benefits by States, FY 2013



Source: Based on review of plan documents and state financial reports. The data reflect the benefit that covers the largest share of state retirees and may not reflect recent plan design changes for new retirees or new workers.

Appendix 1 at the end of this section offers more detail on the different approaches states take on providing retiree health care and the relative fiscal impact. Each bar represents the total retiree health care liabilities per state, scaled by state personal income. For example, Alabama's retiree health care liabilities equal about 7.1% of state personal income, eighth highest among all 50 states. The bars are also color coded to represent which of the three approaches to providing retiree health benefits is most common in a state. The top 25 states as ranked by retiree health care obligations as a share of state income all provide a percentage of premium subsidy to retirees.

Comparing Alabama to regional neighbors, we see that Alabama is one of six states among 10 southern states to offer a benefit based on a percentage of premiums to all retirees. Arkansas offers a fixed subsidy to all retirees while Tennessee pays a percentage of premiums for retirees not yet on Medicare but drops to a fixed subsidy for those older than 65. Florida and Mississippi require retirees to pay the entire premium though Florida does offer a small supplement through the pension benefit to help defer some of those costs.

**Regional Comparison States, Type of Benefit and Size of Liability**

State	Type of Benefit		Dependent Coverage	Retiree Health Care Liability	Liability / Share of State Income	Rank
	Pre-Medicare	Medicare Eligible				
<b>Alabama</b>	Percent of Premium	Percent of Premium (Max. 100%)	Yes	\$12,459,751	7.1%	2
<b>Georgia</b>	Percent of Premium	Percent of Premium (Max. 75%)	Yes	\$19,264,310	5.2%	4
<b>Kentucky</b>	Percent of Premium*	Percent of Premium* (Max. 100% plus fixed contribution)	Coverage only	\$6,429,092	4.1%	6
<b>Louisiana</b>	Percent of Premium	Percent of Premium (Max. 75%)	Yes	\$8,543,177	4.5%	5
<b>North Carolina</b>	Percent of Premium	Percent of Premium (Max. 100%)	Coverage only	\$26,943,108	7.1%	1
<b>South Carolina</b>	Percent of Premium	Percent of Premium (Max. 72%)	Yes	\$10,101,175	6.0%	3
<b>Tennessee</b>	Percent of Premium	Fixed Premium Contribution	Yes	\$1,442,208	0.6%	10
<b>Arkansas</b>	Fixed Premium Contribution	Fixed Premium Contribution	Yes	\$2,148,523	2.0%	7
<b>Florida</b>	Coverage without Contribution or No Coverage	Coverage without Contribution or No Coverage	Coverage only	\$7,487,707	0.9%	8
<b>Mississippi</b>	Coverage without Contribution or No Coverage	Coverage without Contribution or No Coverage	Coverage only	\$690,339	0.7%	9

Source: Pew analysis of plan CAFRs, valuations, and other documents. State income data is from the Bureau of Economic Analysis.

Maximum contribution percentages are for Medicare-eligible retiree single coverage.

\*New hires receive a fixed dollar contribution.

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Note that some states that do not provide a subsidy may still have a liability because of legacy benefits or because, by combining retiree health plans with active employee health plans, the state provides an implicit subsidy.

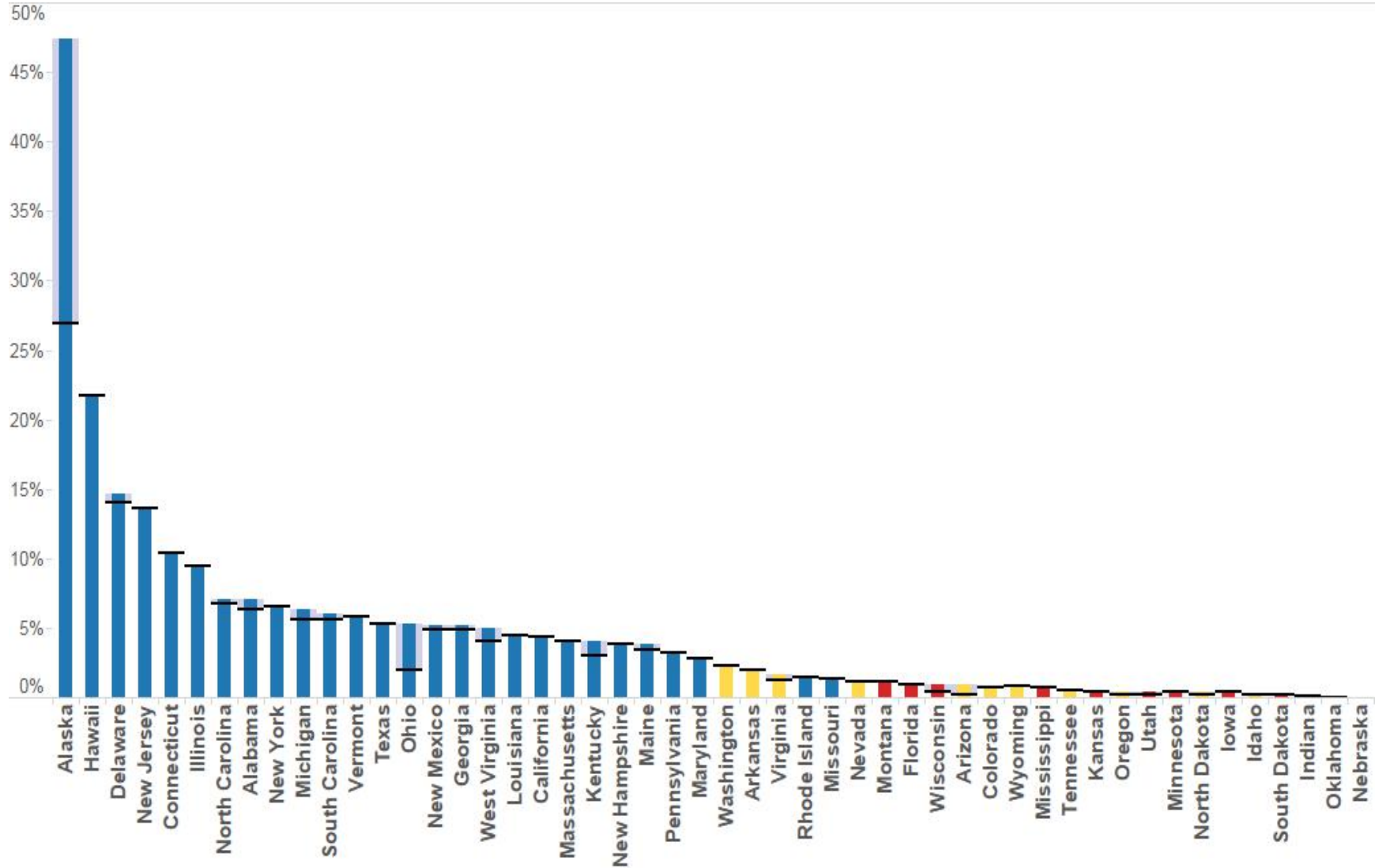
Liabilities for Alabama, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, and Tennessee include state workers and teachers. Liabilities for Arkansas, Florida, and Georgia also include local employees.

Retiree health benefit design, cost, and funding varies substantially. Furthermore, many states have made changes to some aspect of retiree health care benefits—generally finding ways to reduce employer costs. Committee members will need to balance making sure retirees' needs are met and having sustainable costs.

### **Considerations**

1. **Consider measures to control cost growth:** Pew was asked about examples of how states have chosen to reduce or cap future cost growth and what changes would be required to align benefits with other states in the region. West Virginia is the clearest example of protecting against health care cost inflation, setting a maximum amount that employer retiree health care payments can increase annually. A thorough analysis of any changes would include estimates to the impact on cost, OPEB liabilities, and workers' retirement security.
2. **Consider a more comprehensive policy on pre-funding:** Alabama has started pre-funding retiree health benefits for teachers. If Alabama is committed to continuing to offer substantial retiree health benefits on an ongoing basis, pre-funding is an appropriate way of financing those liabilities with greater stability in contributions and lower long-term costs.

**Section Appendix 1: OPEB Liabilities to Personal Income**



Source: Liabilities and asset data are from Comprehensive Annual Financial Reports, actuarial reports and valuations, or other public documents, or as provided by plan officials; personal income data are from the U.S. Bureau of Economic Analysis.

Purple shading indicates plan assets; the bar represents total liabilities as a percentage of personal income.

**Section Appendix 2: OPEB Governance**

The SEHIP and PEEHIP boards make decisions regarding benefit structure and plan design which affects the total premium and set the base employer share of premiums. Legislators have also made changes to the benefit structure, changing cost sharing for those retiring after 2005 and again for workers retiring after 2012. Finally, steps to begin pre-funding can result in long-term lower costs if continued.

Pew reviewed board structure for 22 states, including Alabama and nine regional neighbors. This review found that Alabama had a relatively high percentage of member representatives as board trustees—the average plan board had 35% of trustees representing members while the boards for SEHIP and PEEHIP had 45% and 80% respectively. State retiree health care board composition varies significantly—for example the percentage of ex officio members ranged from none in four states to 88% in Delaware. In Georgia and Hawaii all board trustees were appointed with no member representation while Colorado had 12 of 13 board trustees elected from plan participants.

**SEHIP Plan:** “The contribution requirements of the plan members and state agencies are established and may be amended by the Board of Directors of the Board. The required contribution is based on projected pay-as-you-go financing requirements, with an additional amount to prefund benefits as determined annually by the Board.”

*State Employees’ Insurance Board Financial Statements, September 30, 2014, page 46.*

**PEEHIP Plan:** “The Code of Alabama 1975, Section 16-25A-8 and the Code of Alabama 1975, Section, 16-25A-8.1 provide the Board with the authority to set the contribution requirements for plan members and the authority to set the employer contribution requirements for each required class, respectively. Additionally, the Board is required to certify to the Governor and the Legislature, the amount, as a monthly premium per active employee, necessary to fund the coverage of active and retired member benefits for the following fiscal year. The Legislature then sets the premium rate in the annual appropriation bill.”

*Alabama Retired Education Employees’ Health Care Trust Financial Statements, September 30, 2014, page 11.*

**Share of Retiree Health Plan Board**

	<b>Appointed</b>	<b>Member Representative</b>	<b>Ex Officio</b>	<b>Citizen Representative</b>
Alabama SEHIP	36%	45%	18%	0%
Alabama PEEHIP	0%	80%	20%	0%
State Average	34%	38%	23%	5%

Source: Pew review of statutes and plan documents governing board composition covering 22 states.



## GOVERNANCE

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Alabama has over \$33 billion in public funds invested to pay for pension promises made to workers. As described above, the portfolio has an overall investment target of 8% returns and includes over 85% in stocks and alternative assets, and a level of economically targeted investments that is higher than other public funds. Like every public fund, the management of these funds is informed by pension system governance factors, including the state's interpretation of fiduciary law, the composition of the governing boards or trustees, and the actions of managing and operating fiduciaries. Our recommendations on governance are intended to help clarify and build upon, rather than change, existing fiduciary standards and to consider the role of outside experts to complement RSA's highly qualified investment staff.

### **Fiduciary Law**

Our previous analysis included a study of the fiduciary provisions that govern the Alabama retirement system as well as a comparison of the ERS and TRS board composition to other states. The fiduciary review was based on the core fiduciary provisions identified in the Uniform Management of Public Employee Retirement Systems Act, as well as the Uniform Prudent Investor Act to the extent they are included in law of other states. They provide a picture of how Alabama statutory law compares with other states.

RSA has written that many of these provisions are accounted for through a combination of Alabama state laws, court rulings, constitutional provisions and statements in the RSA investment policy. While Pew maintains the view that there is value in making these provisions explicit in statute, we certainly do not dispute the expertise of in-state legal experts and recognize that there is no one size fits all solution to pension fund governance.

Taking these analyses and feedback into account, our recommendation is to consider adding to rather than changing the existing fiduciary requirements in two areas. First, to make it explicit in the statutory provisions governing the retirement system that the assets of that system are held solely in the interest of participants and beneficiaries, and second that the in-state and economic investments are held to the same risk, return, and other requirements as all other investments.<sup>13</sup>

### **Governance Rules**

The obligation to act prudently has been a core fiduciary obligation for trustees since 1830.<sup>14</sup> It has been a part of virtually every subsequent codification effort along with the duty of loyalty

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<sup>13</sup> A fundamental best practice proposed by the Committee on Fund Governance is that government policies should provide for clear lines of authority between its governing body (e.g., the Board of trustees) and its staff (administration) that reflect a commitment to representing the best interests of the beneficiaries, and are clearly defined and regularly reviewed. In Alabama, the Attorney General of Alabama has been asked to clarify the lines of the authority of both the Board of Controls' and the Secretary-Treasurer on multiple occasions. As a result, the Boards and their Secretary- Treasurer may need additional statutory guidance on their respective roles and their lines of authority.

<sup>14</sup> See *Harvard College v. Amory*, 26 Mass. (Pick) 446 (1830)

that a fiduciary must act exclusively for the participants and beneficiaries. As investments have evolved, fiduciary duties and prudence have as well to take account modern portfolio theory through diversification standards and the consideration of risk and rate of return in making prudent investment decisions and these duties have been specifically recognized in the Uniform Prudent Investor Act and under Alabama's Uniform Trust Code. Coupled with the duty of loyalty and the duty of impartiality, these have evolved as the core of fiduciary law. However, these duties have not been expressly included in the statement of fiduciary duties governing the ERSA or TRSA and the Alabama Uniform Trust Code was not explicitly made applicable to the Boards of Control.<sup>15</sup>

The statement of Investment Policies and Procedures of the Boards of Control recognizes the need to invest so as to maximize the total return of each System within prudent risk parameters. It also states that, "the Systems recognize that a stronger Alabama equates to a stronger Retirement System and as such, investments in Alabama businesses are encouraged to the extent the investment meets the criteria," of this statement. However, the statement does not provide specific guidance to the process for evaluating an investment which has both an investment return objective and an economically targeted objective. In addition, while the Alabama Supreme Court has been clear that prudent investor standards are the purview of the Boards of Control, it has also held that the internal "Investment Policies and Procedures" adopted by the RSA didn't create a "legal duty" or prohibition and were not legally binding in any event.<sup>16</sup>

Clarifying the law and/or policy related to fiduciary prudence would help to ensure that all investments are held to the same standards with respect to risk, return, and diversification while also allowing for inclusion of the investments that also provide ancillary benefits. It is commonly understood that the plan is to be established and operated for the exclusive benefit of employees and their beneficiaries. This concept is identified in the model acts, and is a requirement of qualified plans according to the IRS.<sup>17</sup> The majority of states have this concept clearly spelled out in law, and many have also expanded upon the provisions of prudent investing and primary duty to be more explicit as to how investment with collateral benefits may be analyzed.

### **Economically Targeted Investments**

Fiduciaries of public pension plan face unique challenges under prudent person or investor standards when evaluating in state or other economically targeted investments. Fiduciaries of a public pension plan often consider their duties to the taxpayers, even though they have the duty

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<sup>15</sup> In *Ex Parte Bronner* the Alabama Supreme Court indicated that provisions of the Uniform Trust Code "may shed light" on duties of RSA at page 19.

<sup>16</sup> *Id* at page 27, footnote 10.

<sup>17</sup> The Internal Revenue Code provides 1. The pension plan must be established and operated for the exclusive benefit of employees and their beneficiaries; 2. The plan must make it impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries ...for any of the corpus or income to be ...used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries. (IRC §401(a)(2))

to act “solely in the interest of the participants and beneficiaries,<sup>18</sup> which generally means that the fiduciary must place duty to the plan participants and beneficiaries above any other duty the fiduciary may have.<sup>19</sup> Consequently, there is value to clear guidance so that fiduciaries have appropriate standards to help them weigh economic benefits or other benefits beyond the rate of return to the pension plan.

Rather than prohibiting all economically targeted investments or in-state investments, many states have provided additional guidance to pension plan fiduciaries. Some states have adopted standards similar to those that govern economically targeted investments for all private pension plans. The Government Finance Officers Association has issued best practice recommendations for public pension investments where considering investment with collateral benefits<sup>20</sup>:

1. All investments must yield a rate of return commensurate with the recognized level of investment risk,
2. Fiduciaries who evaluate investments on the basis of the collateral benefits the investments would provide should also consider alternative investments with similar risk/return characteristic,
3. The selected investment should be prudent on its own merit, regardless of the collateral benefits it offers, and
4. Investments with below market returns or other concessionary terms are not acceptable because they compromise established risk-return standards and conflict with fiduciaries responsibility to invest the systems assets for the exclusive benefit of participants.

The Alabama Supreme Court decision *Ex parte David Bronner* recently addressed the criteria under which the Alabama pension funds are administered in the context of a case dealing with sovereign immunity. It noted the “[l]ack of judicially discoverable and manageable standards” in making such investments, citing the need to defer to other branches of government for oversight of such choices.<sup>21</sup> The Alabama Supreme Court also held that Alabama’s “prudent man rule” doesn’t provide a specific enough duty that can serve as a basis for court review.<sup>22</sup> The Alabama Supreme Court held that the internal “Investment Policies and Procedures” adopted by the RSA didn’t create a “legal duty” or prohibition and were not legally binding in any event.<sup>23</sup> This indicates that state law and RSA’s investment policy may not provide clear guidance to assess economically targeted investments that would hold these investments to the same risk and rate of return standards as other investments.

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<sup>18</sup> *Ex parte David Bronner, in his official capacities as chief executive officer and secretary-treasurer of the Employees’ Retirement System of Alabama and as chief executive officer and Secretary-Treasurer of the Teachers’ Retirement System of Alabama, et al*, page 19, Supreme Court of Alabama, October Term, 2014-2015, #11110472, first published on December 31, 2014. Subject to revision before publication in the Southern Reporter.

<sup>19</sup> See, for example, ERISA section 404(a) (1), UMPERSA pages 23-24, citing *NLRB v. Amax Coal Co.*, and 453 U.S. 322 (1981) and *City of Sacramento v. Public Employees Retirement Sys*, 280 Cal. Rptr. 847 (Cal. Ct. App. 1991).

<sup>20</sup> GFOA Best Practice, Public Employee Retirement System Investments, October 2009

<sup>21</sup> In *Re: Bronner*, Supreme Court of Alabama, 12.31.14 at page 39.

<sup>22</sup> *Id* at page 26.

<sup>23</sup> *Id* at page 27, footnote 10.

Given the importance of these decisions to the investment performance of the plans, the legislature should clearly establish the appropriateness of these investments and the process for their consideration. A number of states have taken measures to make this explicitly clear in state law and/or the investment policy statement. Specific language could be: “In investing and managing assets of a retirement system, a trustee with authority to invest and manage assets may consider benefits created by an investment in addition to investment returns only if the trustee determines that the investment providing these collateral benefits would be prudent even without these collateral benefits.

**Size of the Boards of Trustees**

The Council of Institutional Investors recommends, “[a]bsent compelling, unusual circumstances, a board should have no fewer than five and no more than 15 members (not too small to maintain the needed expertise and independence and not too large to function efficiently).” (See CII Corporate Governance Policies 2.11 Board Size and Service) The Council of Institutional Investors is a nonprofit, nonpartisan association of corporate, public, and union employee benefit funds and endowments. The Council voting members include 125 pension and other benefit funds with \$3 trillion in combined assets under management. The best practices we listed are based on the Best Practice Principles adopted by the Committee on Fund Governance of the Stanford Institutional Investors’ Forum.

**Board Investment Expertise**

Our research has found that Alabama’s Board of Control is different from the Boards of Trustees of other state public retirement plans in two respects: its size and the lack of taxpayer/expert representation on the respective Boards of Control. The table below summarizes the composition of the ERS and TRS boards compared to the average pension board.

**ERS and TRS Board Composition Compared to Average Pension Board**

	Total Number of Board Members	Share of Board That Is			
		Ex Officio	Appointed	Member Elected	Public Representative
ERS	13	31%	23%	46%	0%
TRS	15	20%	0%	80%	0%
Average Plan	9.1	17%	20%	35%	28%

Source: Andonov, Bauer, Cremers, Pension Fund Asset Allocation and Liability Discount Rates, June 2015.

We have recommended that the state consider increasing outside investment expertise of the board by providing that investment committee members have desired financial expertise in areas such as investment management, financial, economics, pension administration, and accounting or actuarial expertise to strengthen the analytic capabilities of the boards’ investment committees.

Both committee members and other stakeholders have requested a more in-depth study of these matters, which we have agreed to continue researching.

We make note of the strong investment expertise of the RSA staff, which include 12 CFAs, as well as the State Treasurer and the State Finance Director (both ex officio members of the board). We recognize the diligence of pension system staff in constructing and implementing an investment policy and neither board members nor legislators should be micromanaging plan investment choices.

### **Considerations**

1. **Build on existing fiduciary law to clarify the primary purpose of the fund and the evaluation of investments with economic benefits:** We recommend making these provisions explicit in statute in order to add to, rather than change, existing fiduciary law and to remove ambiguity with regard to trustee duties and priorities. Analysis and specific language is included in Appendix C based on a review of model practices and statutory provisions in other states.
  - a. In accordance with the provisions of the Uniform Prudent Investor Act and Uniform Management of Public Employee Retirement Systems Act, make explicit that: A trustee or other fiduciary shall discharge duties with respect to a retirement system solely in the interest of participants and beneficiaries. (Language included in Appendix C).
  - b. Establish in statute that any party delegated authority to invest and manage plan assets may consider benefits created by an investment in addition to investment return only if that trustee or party determines that the investment providing these collateral benefits would be prudent even without the collateral benefits. (Language included in Appendix C.)
  
2. **Further study the investment expertise requirements for trustees and investment committee members:** Model practices and research point to the value of having explicit expertise to complement the investment skills of professional staff. Committee members and other stakeholders have requested a more in-depth study of these matters, and we have agreed to provide further research.

## SUMMARY OF RECOMMENDATIONS AND CONSIDERATIONS

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### **Funding**

1. **Adopt a policy to regularly provide stakeholders with stress test analysis that projects plan costs under different economic and investment return scenarios:** Projected pension costs are based on a number of actuarial and investment return assumptions. Stress testing can help policymakers better understand and plan for cost uncertainty if assumptions are not met. This recommendation is informed by our analysis of the historical causes of the unfunded pension liability and consistent with recent recommendations by the Society of Actuaries Blue Ribbon Panel on pension funding. It also builds on new government accounting rules that require limited stress tests in certain plan documents. Alternative investment scenarios should also be applied to the cost analysis for changes in retirement policy. We also recommend that this enhanced reporting include a calculation of the projected change, or amortization, in pension debt under current policy over a 10 to 20 year period.
2. **Consider shortening phase-in of contribution policy:** The contribution policy adopted in 2013 will take 15 years to fully go into effect. As a result, pension debt will not be paid off in full until at least 2050. Shortening or eliminating the phase-in period would increase costs in the short-run but reduce costs in the long-run and speed up full funding. Pew's analysis found that eliminating the remaining phase-in would cost an extra \$600 million total through 2030 but save \$1.6 billion from 2030 to 2060 for a net savings of \$1 billion. Costs and savings are adjusted for inflation.
3. **Require actuarial funding of benefit increases:** To ensure pension benefits are fiscally sustainable, any future increase in benefits, including Cost of Living Adjustments, should require an appropriation to pay for any increase in the unfunded liability.

### **Investments**

4. **Improve transparency in pension investment reporting:** Alabama meets required standards of disclosure and reporting. Recommended improvements that would make Alabama an industry-wide leader in reporting practices include:
  - a. Providing performance figures on a net-of-fee basis in addition to current gross-of-fee reporting.
  - b. Extending reporting time horizons for performance to include the 20-years or more.
  - c. Reporting performance (net- and gross-of-fees) for all asset classes, including separate reporting for fixed income, private placements, private equity and real estate.
  - d. Adopting reporting standards for private equity fee reporting as proposed by the Institutional Limited Partnership Association.

### **Current Benefits**

5. **Provide a life-cycle or target date fund through RSA-1:** The investment options in RSA-1 meet two key best practices—a limited number of options with low-fees. By incorporating a third best practice, including a life-cycle or target date fund, individual workers can benefit from the investment expertise of RSA staff and/or external investment managers and will not have to balance and rebalance their investments between equities and fixed income.
6. **Implement default contributions and auto-escalation for existing DC plans to increase worker savings:** Our research indicates that many public workers in Alabama may not be saving enough for retirement under current policy. Auto-escalation, automatic enrollment, and default employee contributions are tools that encourage workers to increase their retirement savings while still giving employees the opportunity to opt out of the rate or plan.<sup>24</sup> Automatic enrollment with a default contribution rate of 2% would encourage participation. Auto-escalation, where employee DC contributions increase by a modest amount each year, is another way to help workers save. Setting contribution rates to increase by 0.5% a year until hitting a cap would allow auto-escalation to be built into Alabama DC benefits.
7. **Consider a review of Alabama Deferred Compensation Plan investment choices and fees:** Best practices in defined contribution plan design include offering a small number of investments options with low fees through the use of index funds. The Alabama Deferred Compensation Plan should consider reviewing the available investments option to make sure none are duplicative and that fees are appropriately low.

### **Plan Design for New Hires**

8. **Consider and evaluate new plan design options based on impacts to cost predictability for the state and retirement security for all workers.** This memo includes information on cash balance plans and risk based cost sharing within DB plans. Note that funding is essential regardless of plan design. No new plan design will eliminate the unfunded liability and necessity of consistent actuarial funding.

### **Retiree Health Benefits**

9. **Consider measures to control cost growth:** Pew was asked about examples of how states have chosen to reduce or cap future cost growth and what changes would be required to align benefits with other states in the region. West Virginia is the clearest example of protecting against health care cost inflation, setting a maximum amount that employer retiree health care payments can increase annually. A thorough analysis of any changes would include estimates to the impact on cost, OPEB liabilities, and workers' retirement security.

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<sup>24</sup> John Beshears, James J. Choi, David Laibson, & Brigitte C. Madrian, "The importance of default options for retirement saving outcomes: Evidence from the United States." In *Social security policy in a changing environment* (pp. 167-195). University of Chicago Press (2009).

- 10. Consider a more comprehensive policy on pre-funding:** Alabama has started pre-funding retiree health benefits for teachers. If Alabama is committed to continuing to offer substantial retiree health benefits on an ongoing basis, pre-funding is an appropriate way of financing those liabilities with greater stability in contributions and lower long-term costs.

### **Governance**

- 11. Build on existing fiduciary law to clarify the primary purpose of the fund and the evaluation of investments with economic benefits:** We recommend making these provisions explicit in statute in order to add to, rather than change, existing fiduciary law and to remove ambiguity with regard to trustee duties and priorities. Analysis and specific language is included in Appendix C based on a review of model practices and statutory provisions in other states.
- a. In accordance with the provisions of the Uniform Prudent Investor Act and Uniform Management of Public Employee Retirement Systems Act, make explicit that: A trustee or other fiduciary shall discharge duties with respect to a retirement system solely in the interest of participants and beneficiaries. (Language included in Appendix C).
  - b. Establish in statute that any party delegated authority to invest and manage plan assets may consider benefits created by an investment in addition to investment return only if that trustee or party determines that the investment providing these collateral benefits would be prudent even without the collateral benefits. (Language included in Appendix C.)
- 12. Further study the investment expertise requirements for trustees and investment committee members:** Model practices and research point to the value of having explicit expertise to complement the investment skills of professional staff. Committee members and other stakeholders have requested a more in-depth study of these matters and we have agreed to provide further research.



## APPENDICES

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### APPENDIX A

#### Outstanding questions from December 1, 2015 meeting of the JCAPP

##### Funding

1. *How can we assess the impact on funding and cost if markets underperform?* See Funding Section.
2. *What would the impact be of an immediate lump sum infusion, for example from the BP settlement funds?*  
Alabama's \$15 billion in pension debt will impose a substantial cost to the state and local governments as it is paid off. Using some part of the BP funds to pay off a portion would help improve funding and reduce costs. If, for example, \$1 billion was put into the pension fund in 2018, future employer costs would be reduced by \$2 billion over the next 45 years, after adjusting for inflation. That adds up to a net savings of \$1 billion. However, we understand that the BP funds are being received by the state in increments. If, for example, \$100 million were put into the pension fund today, it would reduce future costs by approximately \$200 million over the next 45 years, adjusting for inflation, amounting to a net savings of \$100 million.
3. *Is it possible to increase accountability for meeting the 8% investment return assumption?*  
Some states have set policies that share gains and losses from returns between employer and employee. For example, Arizona public employees have their contributions go down if strong plan returns lead to improved funding but have to pay more towards pensions if returns fall short. Plan designs that share risk create a situation where all stakeholders have a direct stake in the investment returns

##### Investments

4. *Are Alabama's investments riskier than typical?* See Investments Section.
5. *How does Alabama perform factoring in fees?* See Investments Section.
6. *Is it fair to say that Alabama's private equity, private placement, and real estate investments underperform?* See Investments Section.
7. *Is Raycom an Alabama investment?*  
Yes. Several RSA commissioned studies evaluating in-state and economically-targeted investments have specifically identified Raycom as an economically targeted investment. While RSA does have a substantial business presence outside Alabama, its headquarters is in Alabama.

8. *How common is it for a pension plan to be a significant landlord for the plan sponsor?*  
Pew's review of public pension plans indicates this is an uncommon practice but that Alabama's situation is not entirely unique. For example, the Police and Fire Pension Fund of Jacksonville, Florida redeveloped and owns its headquarters and the attached parking garage and had owned a building that was leased by the city to use for office space. In 2013 the city exercised its option in the lease to buy the latter building from the Fund.
9. *Is it unusual for a plan to be heavily invested in media companies?*  
RSA and other public pension funds typically have investments in media companies through their allocation to a diversified portfolio of publicly traded stocks and in some cases, may also invest in these companies through their private equity partnership investments. RSA's investment in Raycom and Community Newspaper is unusual both because the private placements and private equity holdings represent such a significant percentage of the total investment portfolio (10%) and also because the investment is made directly by the pension fund.

### **Governance**

10. *Is there a recommended number of trustees on a board?* See Governance Section.
11. *What research supports list of best practices for board composition?* See Governance Section.

### **Pension Benefits**

12. *Would alternative designs increase cost predictability?* See Plan Design for New Hires Section.
13. *Should employees' DC savings be in risky assets?* See Plan Design for New Hires Section.
14. *Do any states cap costs on either pensions or retiree health benefits?*  
States such as Alaska, Michigan, and Oklahoma that offer a defined contribution plan as the sole benefit have effectively capped their costs as a share of payroll for new hires. Another approach that keeps the final average salary framework from a defined benefit is Utah's hybrid model where the employer contribution is fixed at 10% and any additional costs are paid for by employee contributions. Other states and localities have not capped costs but did make changes to improve cost predictability by sharing risk. For examples of capping costs for retiree health benefits, see the below section.

### **Retiree Health Benefits**

15. *Are Alabama's retiree health benefits the most generous regionally?* See Retiree Health Benefits Section.
16. *What other approaches have states taken to deal with retiree health care costs?* See Retiree Health Benefits Section.
17. *How do other states set up retiree health care boards?* See Retiree Health Benefits Section.

18. *Do any states cap costs on either pensions or retiree health benefits?*

States such as Montana and Mississippi offer no direct retiree health benefit subsidy, while Michigan has moved to a defined contribution framework, as has North Dakota for pre-Medicare retirees. An interesting example that may be applicable to Alabama is West Virginia's 2013 policy change where, going forward, per beneficiary costs could not grow more than 3% annually. If health care cost inflation is below that, benefits remain the same but if costs grow faster then retiree premiums will make up the difference. For examples of capping costs for pension benefits, see question number 14.

19. *Do states restrict retiree health benefits only to spouses without other available insurance?*

Alabama currently charges a \$50 dollar monthly premium surcharge for state retirees receiving a spousal benefit where the spouse is otherwise eligible for other health insurance coverage. This surcharge could be expanded if policymakers choose.

**Other**

20. *How can we improve education on public sector retirement issues?*

Participant education on public retirement issues is a critically important component of plan function. Many participants are unaware of the funded status of their plan and the size of their contribution to the plan. Part of the education component of a retirement plan is basic information about the plan, including plan administration, benefit design, eligibility requirements, the source of financing and the procedures for claiming benefits and appealing determinations. A separate kind of information is the annual disclosure of financial and actuarial status that should include, among other things, the funded status of the plan, investment objectives and policies, the schedule of rates of return over recent periods including the performance net of fees. Of course the disclosure should include basic information about the amount of the state or local government contribution on their behalf, together with a disclosure of how much they are actually contributing to the plan and the value of their benefit in an individual benefit statement.

More recently there has been a growing interest in providing participants with information about the aggregate value of plan savings attributable to the participants and what that amount means in terms of their monthly or annual benefit assuming that they work until retirement. Finally, where a defined contribution component is in place, the information should be much more comprehensive, including the participant risk and the value of the benefit if held until retirement. Some plans and mutual funds now include on line tools so that participants can better understand their need to make consistent contributions to build the assets in their account.

## APPENDIX B: Cost Neutral Cash Balance Plan Option

Policymakers considering pension plan design must balance retirement security, cost, and risk. This section provides an example of the analyses that allow for this balancing. A request for information on cash balance plan designs was made by the co-chairs of the Joint Committee on Alabama Public Pensions and additional questions on this design were posed by RSA. As a result, this section focuses on an example cash balance plan that would have a similar expected cost to the current plan. These same analytical approaches can be applied to any plan design—Pew will analyze other pension design approaches upon request.

The analysis of a cost-neutral cash balance plan does not constitute a recommendation by Pew of cash balance designs in general or this specific cash balance proposal in particular. Instead this section is intended to demonstrate four key concepts:

- Plan type does not determine cost: Any plan type can be designed to give a high benefit at high cost or a low benefit at low cost. This specific cash balance plan is designed to be cost-neutral based on feedback from the JCAPP co-chairs, but policymakers could choose to make changes that would lower or increase expected costs.
- Benefit comparisons should analyze multiple career tenure scenarios: A given plan design will have a different impact on different types of workers, in particular workers joining at a young age versus those later in career and workers who stay for 10 or 20 years as opposed to a whole career.
- Analyze both expected and actual cost: In 2014, the expected cost for new benefits alone was 1.1% of payroll but *actual* costs (that include payment for accumulated unfunded liability) were 10 times that. Only looking at an expected cost scenario will hide the risks that the state or local employer assumes from investments and other actuarial assumptions. Similarly, if employee benefits depend on investment returns or can otherwise vary based on economic or financial developments, benefit analysis should include multiple scenarios.
- Policymaking must balance cost, risk, and retirement security: Current benefit designs in Alabama have relatively low expected cost and provide relatively low benefit with high cost uncertainty for employers. The benefit design analyzed below is expected to have a similar expected cost with lower risk to the employer. However, policymakers considering plan modifications that trade higher expected cost and higher retirement security for lower employer risk may find options that strengthen the state fiscally while providing a better benefit for workers.

Benefits under a cash balance plan are based on the value of individual employee retirement accounts maintained by the state. Employee accounts grow as workers and their employers make annual contributions to the plan—called the pay credit—and as investment returns—called interest credits—accumulate on those contributions. The primary way that cash balance pension plans are different than defined contribution (401(k)-style) plans is that employees' cash balance accounts are guaranteed a minimum annual investment return. Investment returns in excess of this minimum guarantee can be shared with employees or saved by the plan for years when actual

returns fall short of the minimum. Upon retirement, employees are eligible to receive a lifetime benefit based on the accumulated value of their account. This lifetime benefit, or annuity, can be structured various ways to provide employees with significant flexibility in how they receive benefits. More background on cash balance plan designs is available in Pew's brief on cash balance designs.<sup>25</sup> The following section is somewhat technical and focuses on setting the parameters for a cash balance with similar expected costs to current benefits.

### **Cost-neutral cash balance plan parameters**

As noted above, there are three key policy parameters: the pay credit, the interest credit, and the annuity calculation. In the JCAPP October presentation, RSA's actuary, Cavanaugh Macdonald, presented a specific cash balance design implemented in Kentucky. The pay credit was 9% of payroll, with 5% from employee contributions. The interest credit included a guaranteed return of 4%. Public workers who remain active employees have access to gain sharing: if returns are higher than that based on a five year average, 75% of the gain goes to employee accounts and 25% is retained by the plan. Workers who leave before retirement can keep their money in the plan but only get the 4% guarantee. At retirement annuities are provided based on the plan's assumptions regarding investment returns and longevity. Cavanaugh Macdonald estimated that applying these plan provisions to Alabama would cost employers 2.81% of payroll for new benefits for state workers and 2.51% for teachers. These expected costs for that cash balance plan would be higher than the expected cost of new benefits for Tier 2 employees for both state workers and teachers, though less than the 11% of payroll that Alabama currently pays to cover both new benefits and the accumulated debt from investment losses and policy choices. Under the design presented by Cavanaugh Macdonald, new employee contributions would go down to 5% of salary.

Based on this analysis from Cavanaugh Macdonald, Pew projected parameters for a cash balance design that would match the current cost of new benefits for state workers in Alabama for both employer and employee. Looking at state workers, Cavanaugh Macdonald estimated that a 7.81% combined employer and employee contribution would be sufficient to pay for a 9% pay credit for state workers. The difference between cost and pay credit has two sources—first, a five year vesting rule means that not all workers qualify to get the employer share of the pay credit. Second, the interest credit rules are expected to provide workers with a lower return than the assumed 8% in a median scenario based on stochastic analyses of returns. Pew estimates that a 7.5% combined pay credit, with 6% employee contribution, would result in an estimated employer contribution comparable to current costs for a new Tier 2 state employee. As noted, this estimate is based on Cavanaugh Macdonald's original estimate for the cost of a cash balance plan in Alabama—if those original estimates are revised than subsequent findings would need to be revised. If policymakers choose to develop a cost-neutral cash balance plan design, final parameters should be confirmed after a cost estimate is produced by the RSA actuary.

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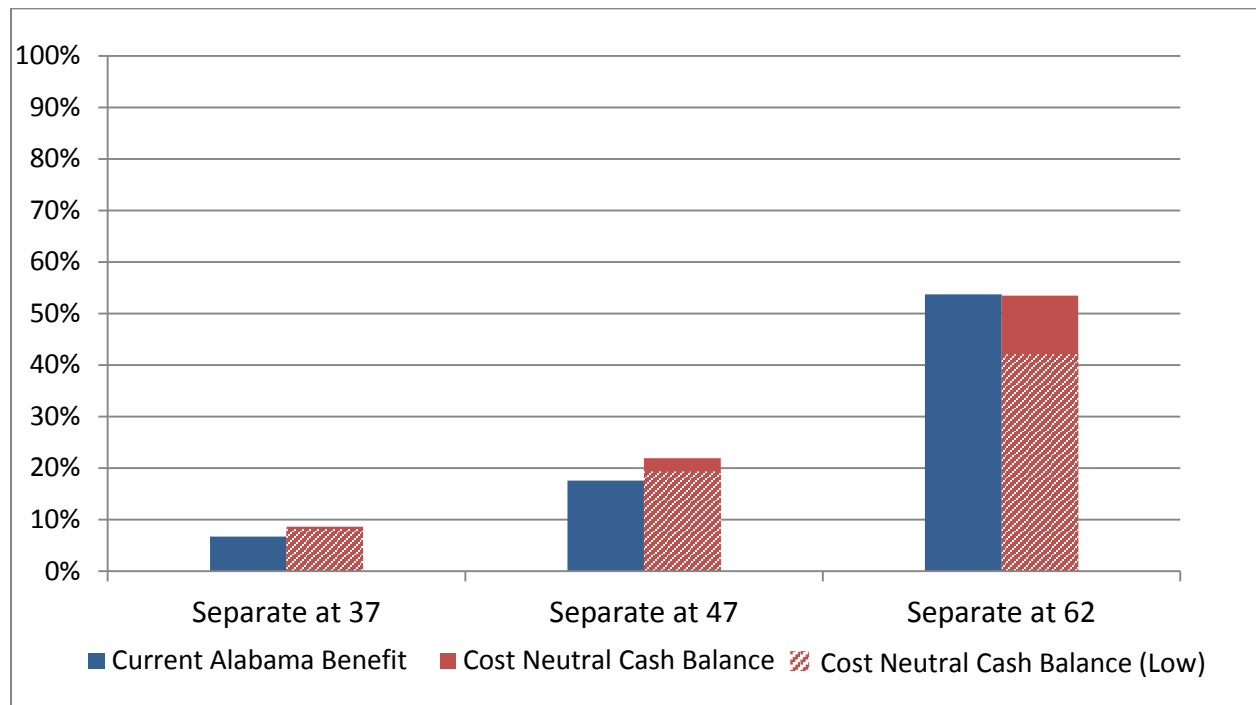
<sup>25</sup> <http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2014/02/12/public-pension-cash-balance-plans>

**Benefit Analysis**

The analysis below describes how a cash balance plan with a 7.5% pay credit and parameters described above compares to current benefits for Alabama state workers regarding both retirement security and cost predictability. Pew’s standard benefit analysis analyzes a worker starting at age 27 and estimates what his or her retirement benefit would be as a percentage of end-of-career salary based on staying with public employment in Alabama for 10 years, for 20 years, and for 35 years to retire at 62. These assumptions are based on a typical start age and analyze a distribution of career lengths. Salary data and longevity data were taken from assumption used by the Retirement System of Alabama.

If long-term returns met the expected rate of 8%, effective interest crediting for plan participants was estimated to be 7.85% and in a scenario where long-term returns were just 6%, the interest crediting rate was projected to be 6.55%. Annuities were provided based on the plan assumed rate of return of 8%—if the plan instead used a lower rate to provide annuities it would lower both benefits and costs. Workers who leave service are estimated to keep their savings in the retirement system until retirement age and utilize the annuity option. Workers who separate before the retirement age receive the 4% return guarantee until retirement eligible.

**Replacement Income at Retirement, State Worker Starting at 27**



Source: Analysis by Pew and The Terry Group

The results show that workers who join at 27 and don't spend a full career with Alabama would be better off under a cost-neutral cash balance plan. For career workers, the current plan gives a slightly higher expected benefit—furthermore the current plan offers a fixed benefit while the cash balance benefit could be higher or lower if long-term investment returns lag or exceed the 8% target.

The comparison would be different for someone starting at a different age. A worker starting at age 22 instead of age 27 would get a greater advantage from the cash balance design. Someone starting at age 40 would be slightly better off with the cash balance if he or she left Alabama employment after 10 years of service but someone staying until age 62 would get a reduction in benefits from the cash balance.

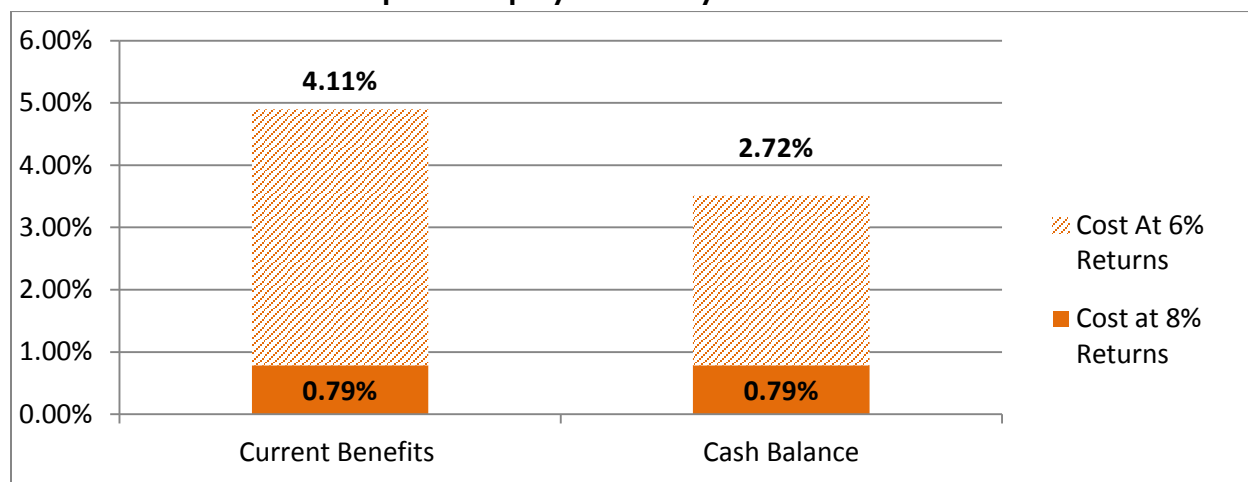
Income replacement figures do not include Social Security. Neither the current nor alternative plans provide built in COLAs so effective income replacement will decline over time due to inflation—this applies to the current final average salary defined benefit as well as the hypothetical cash balance. Because the cash balance plan based on the Cavanaugh Macdonald parameters has five year vesting, all workers who leave with more than five years but fewer than 10 years of service would get a better benefit.

### **Cost and Cost Predictability**

Risk and cost-uncertainty are a key fiscal issue facing policymakers considering pension plan design. By offering an interest guarantee and by providing annuities through the plan, this plan design would retain some risk with the employer. Those same provisions mean that for workers a cash balance plan is a form of defined benefit. However, employer costs do become more predictable—investment return risk is shared in a defined and predictable way and providing benefits through retirement accounts reduces the number of actuarial assumptions that need to be gotten right to accurately predict costs.

Pew projected costs for both the Tier 2 benefits and a cost-neutral cash balance plan. At the expected return both plans had an expected cost of .79% of payroll based on the estimate by Cavanaugh Macdonald. At a low return scenario where over the long-run investments delivered just 6% returns the estimated cost of worker benefits under Tier 2 jumps to 4.11% of payroll. Costs of the cash balance plan would also be expected to increase—to 2.72% of payroll. The cash balance plan's costs are still impacted by investment returns but in this scenario about 40 percent of the risk has been mitigated.

### Projected Employer Costs by Return Scenario



Source: Analysis by Pew and The Terry Group.

Projections are useful analytical tools to understand the range of potential costs—another way of understanding cash balance plans is to look at the examples in states and how they fared during the Great Recession. Texas’ two cash balance plans are the two longest-running examples—the plan for municipal workers was started in 1947 and the plan for county and district employees in 1967. Together they cover over 400,000 active Texas public employees and retirees—state workers and teachers are covered by final average salary plans. Nebraska started cash balance plans for state and county workers in 2002.

The average state pension plan was 85% funded in 2005, had funding drop to 78% after the Great Recession, and saw funding continue to decline to 72% in 2013. To the extent that the cash balance plans had lost ground during the Great Recession they were able to make it up by 2013; Nebraska’s cash balance plan returned to surplus while Texas’ plans are 91% and 86% funded. As with any comparison of public pension plans, there are multiple factors driving these results, not just plan type. The data does suggest that cash balance plans can provide protection against investment risk for employers while giving a guaranteed benefit to workers.

### Funded Status of Example State Cash Balance Plans vs. 50 State Average

% Funded by Year	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>Nebraska Cash Balance</b>	115%	104%	104%	98%	94%	94%	92%	94%	99%
<b>Texas County and District</b>	91%	94%	94%	89%	90%	89%	89%	88%	89%
<b>Texas Municipal Retirement System</b>	83%	82%	74%	74%	76%	83%	85%	87%	84%
<b>50 State Average</b>	85%	85%	86%	83%	78%	75%	74%	72%	72%

Source: Review of plan financial documents and actuarial valuations



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There is no one size fits all solution to plan design and different states have found successes with different approaches. Cash balance plans have worked in the public sector, as have defined benefit, defined contribution, and hybrid approaches. Any consideration of alterations to benefit design in Alabama should apply the key concepts this section lays out—plan *type* does not determine cost as much as plan *design*; analysis should include multiple benefit scenarios and multiple cost scenarios; and policymaking must balance the three factors of cost, risk, and retirement security. Pew will provide analysis as requested on different approaches for Alabama using this framework.

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**Appendix C: Comparison of Alabama State Law Against UMPERSA Standards<sup>26</sup>**

Fiduciary Element <sup>27</sup>	States Adopting	AL Adopts	RSA Comments	Analysis and Recommendations
Prudence requirement	50	Yes	Statutes already require the RSA Board(s) to invest with the “care, skill, prudence, and diligence” of a prudent person.	Pew agrees that this element is contained within the AL statute.
Exclusive purpose of providing benefits	27	Yes	The AL Constitution provides that RSA funds are held for the “exclusive purpose of providing benefits.”	Pew agrees that this element is contained within the AL statute.
Solely in the interest of participants	26	No	The AL Constitution provides that funds are held “as in trust,” the Secretary-Treasurer is required by statute to invest in the best interests of the funds, and the AL Supreme Court has “explicitly acknowledged” that the AL Code requires the trust be administered “solely in the interests of the beneficiaries.”	<p>Pew research indicates that this element is not explicit within AL’s statute. The AL Supreme Court acknowledged that AL trust law may “shed light” on trustee duties and noted that the Plaintiffs and Defendants agreed a fund must be administered solely in the interests of the beneficiaries. However, the Court stops short of explicitly stating that state trust law is applicable in every case. Ultimately, the Court appears to decline substituting the trustees’ judgment with its own.</p> <p><u>Recommendation:</u> Make this provision explicit in the statute by adding the words “A trustee or other fiduciary shall discharge duties with respect to a retirement system solely in the interest</p>

<sup>26</sup> RSA comments provided on May 6, 2015 identify that many of these provisions are accounted for through a combination of Alabama state laws, court rulings, constitutional provisions and statements in the RSA investment policy. While Pew maintains the view that there is value in making these provisions explicit in statute, we do not dispute the expertise of in-state legal experts and focus recommendations on areas where further clarity would be beneficial. Note that this analysis is limited to 6 of the 9 model standards that we deem most relevant for this analysis.

<sup>27</sup> The National Association of State Retirement Administrators (NASRA), of which RSA is a member, has numerous [standing resolutions](#) emphasizing that trustees should adhere to a robust fiduciary standard in the execution of their duties. A summary of the relevant language of those resolutions is as follows:

- **Resolution 1196-06** – NASRA “Supports strong fiduciary standards set in law,” and “supports investment strategies for which the paramount goal is the financial security of pension assets.”
- **Resolution 2011-02** – NASRA “Encourages...strict adherence to...disclosure requirements and ethics policies that demand unassailable conduct by system staff, trustees, and service providers”; and further espouses that public fund fiduciaries should adhere to the following policies:
  - **“Undivided Loyalty to the Fund:** Public fund fiduciaries should abide by the highest ethical standards, making all decisions in the best interest of system participants, placing those interests above all other interests with uncompromising rigidity.”
  - **“Open and Honest Decision-making:** Public fund fiduciaries should act with integrity, objectivity and independence, and make decisions in a fair, honest and open manner”

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				of the participants and beneficiaries” as informed by the UMPERSA Model Act.
Reasonable administrative expenses	22	No	The AL Constitution provides that funds may be used only for benefits, refunds, and expenses that are “diligently and honestly” deemed to be “current and necessary.”	Pew research indicates that this element is not contained within the AL statute. However the constitutional language has relevance and we have separately made recommendations to increase disclosure on pension fund investment fees in a manner than can be expected to highlight RSA’s low fee and expense levels.
Diversification of investments	27	No	Al Statutes (Ala. Code §§ 16-25-20(a), 36-27-25(a)-(f)) and RSA investment policies provide for a diversified portfolio. AL’s common law “Prudent Man” standard also requires diversification (See <i>Denson v. Bronner</i> , at *8).	Pew research indicates that this is element is not contained within the AL statute. RSA believes this element is reflected in the common law “Prudent Man” standard and explicitly within its investment policies.
Economically targeted investments first prudent	8	No	In addition to the aforementioned statutory prudence requirements, RSA investment policies explicitly mandate that ETIs have comparable returns to similar investments. <sup>28</sup>	<p>This standard provides that fiduciaries may consider benefits created by an investment in addition to investment returns only if the trustee determines that the investment providing these benefits would be prudent even without the collateral benefits. Pew research indicates that this is element is not contained within the AL statute. Pew notes that although RSA investment policy incorporates a prudent man standard, it does not define what parameters should be used in evaluating an ETI.</p> <p><u>Recommendation:</u> Provide further clarity by providing, “in investing and managing assets of a retirement system, a trustee with authority to invest and manage assets may consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits” as informed by UMPERSA Model Act and state examples below.</p>

<sup>28</sup> Retirement Systems of Alabama, *Investment Policies and Procedures (CAFR FY 2014)*, at 59. “It is the objective of the Boards that funds be invested in such a manner as to maximize the total return of each System within prudent risk parameters. Also, the Systems recognize that a stronger Alabama equates to a stronger Retirement System, and as such, investments in Alabama businesses are encouraged to the extent the investment meets the criteria delineated by this policy statement.”

Appendix C (Continued): ETI Investment Policies in Other States

1. **California** – The California State Teachers’ Retirement System (CalSTRS) and the California Public Employees’ Retirement System (CalPERS) both have specific language on ETI investing. CalSTRS is required to “give preference to investments focused or based in California” based on its written investment policy. The policy states that all things must be equal, “especially with regard to risk, return, and diversification,” which potentially reaches even further than the UMPERSA standard.<sup>29</sup> CalPERS guidance states that the **“primary objective of CalPERS investments in California is to achieve appropriate risk-adjusted return on investment” and notes that investment in CA is a consequence of the strength and quality of those investments.**
2. **Florida** – Florida’s retirement systems are managed by the State Board of Administration. Florida statute Section 215.47(10) provides that **“Investments made by the State Board of Administration shall be designed to maximize the financial return to the fund consistent with the risks incumbent in each investment** and shall be designed to preserve an appropriate diversification of the portfolio. The board shall discharge its duties with respect to a plan solely in the interest of its participants and beneficiaries. **The board in performing the above investment duties shall comply with the fiduciary standards set forth in the Employee Retirement Income Security Act of 1974** at 29 U.S.C. s. 1104(a)(1)(A) through (C). In case of conflict with other provisions of law authorizing investments, the investment and fiduciary standards set forth in this subsection shall prevail.” ERISA is interpreted to apply the ETI prudence first standard.
3. **Kansas** - No moneys in the [retirement fund] shall be invested or re-invested if the sole or primary investment objective is for economic development or social purposes. KSA § 74-4921.
4. **Maryland** - Maryland has incorporated the provisions of the Model Act or UMPERSA by reference. In 2005, Maryland enacted SB 370, legislation that required the Board of Trustees for the Maryland State Retirement and Pension System and the governing body of any local system established before July 1, 2005, must certify to the Joint Committee on Pensions that the plan provisions governing these public plans adhere to the principles incorporated in UMPERSA that address the investment and management of funds. Although this legislation was enacted, the language relating to the State Retirement and Pension System was not included in the Maryland Code of Laws. A related provision in SB 370 that applied to local pension systems prospectively was codified in the Code of Maryland to require that a local jurisdiction establishing a public pension system on or

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<sup>29</sup> CalSTRS, Investment Branch, *Policy on California Investments* (June 2014). Available at [http://www.calstrs.com/sites/main/files/file-attachments/l\\_-\\_policy\\_on\\_california\\_investments\\_6-2014.pdf](http://www.calstrs.com/sites/main/files/file-attachments/l_-_policy_on_california_investments_6-2014.pdf).

after July 1, 2005, is required to adhere to the principles in UMPERSA. Maryland has also provided detailed criteria on ETIs in its investment policies.<sup>30</sup>

5. **Michigan** - The investment fiduciary (State Treasurer) is to give appropriate consideration to investments which would enhance the general welfare of Michigan and its citizens if those **investment offer the safety and rate of return comparable to other investments permitted under this act and available to the investment fiduciary at the time the investment decision is made.** (§ 38.1133, Sec.13(3)(e). In addition to the foregoing, the investment fiduciary may invest, under certain circumstances, in small businesses, small business investment companies, or venture capital firms that have their principal office or more than one-half their assets or employees within Michigan as applicable (§ 38.1140a,Sec.20a(1). The system may invest not more than 5% of its assets in such investments. (§ 38.1140a, Sec.20a(2)).
  
6. **Ohio** - **In exercising its fiduciary responsibility, the board is to give consideration to investments that enhance the general welfare of Ohio and its citizens where the investments offer quality, return, and safety comparable to other investments currently available to the board.** § 3307.15(B)
  
7. **South Carolina** - **May consider benefits created by an investment in addition to investment returns only if the commission determines that the investment providing these collateral benefits would be prudent even without the collateral benefits.** South Carolina Code of Laws § 9-16-50
  
8. **Wyoming** - Has adopted UMPERSA provisions according to Uniform Law Commission. § 9-3-440. Duties of trustee in investing and managing assets of retirement system.
  - (a) In investing and managing assets of a retirement system pursuant to § 9-3-439, a trustee with authority to invest and manage assets:
    - (v) **May consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits.**

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<sup>30</sup> Maryland State Retirement and Pension System, *Investment Policy Manual*. Available at [http://www.sra.state.md.us/Agency/Investment/Downloads/Investment\\_Policy\\_Manual.pdf](http://www.sra.state.md.us/Agency/Investment/Downloads/Investment_Policy_Manual.pdf).