Public Agenda Item #19

Review and Discussion of Board Policy of Pension Funding Priorities and Guidelines

May 17, 2016

Jennifer Jones, Senior Program Specialist

What Is a Pension Policy?

Emerging Best Practice

ERS

A Pension Policy outlines objectives and procedures for pension contributions

- ☑ Fund the expected cost of all promised benefits (normal cost + unfunded liabilities)
- ☑ Manage contribution volatility and create budget predictability
- ☑ Create intergenerational equity to pay the cost of benefits
- ☑ Balance competing objectives

Bringing It into Focus – What Started the Conversation?	Which Systems Are Creating Policies?
Nationwide pension funding challenges	City of Austin, TCDRS, TMRS
GASB 67/68 requirements	A number of state systems

Project Goals

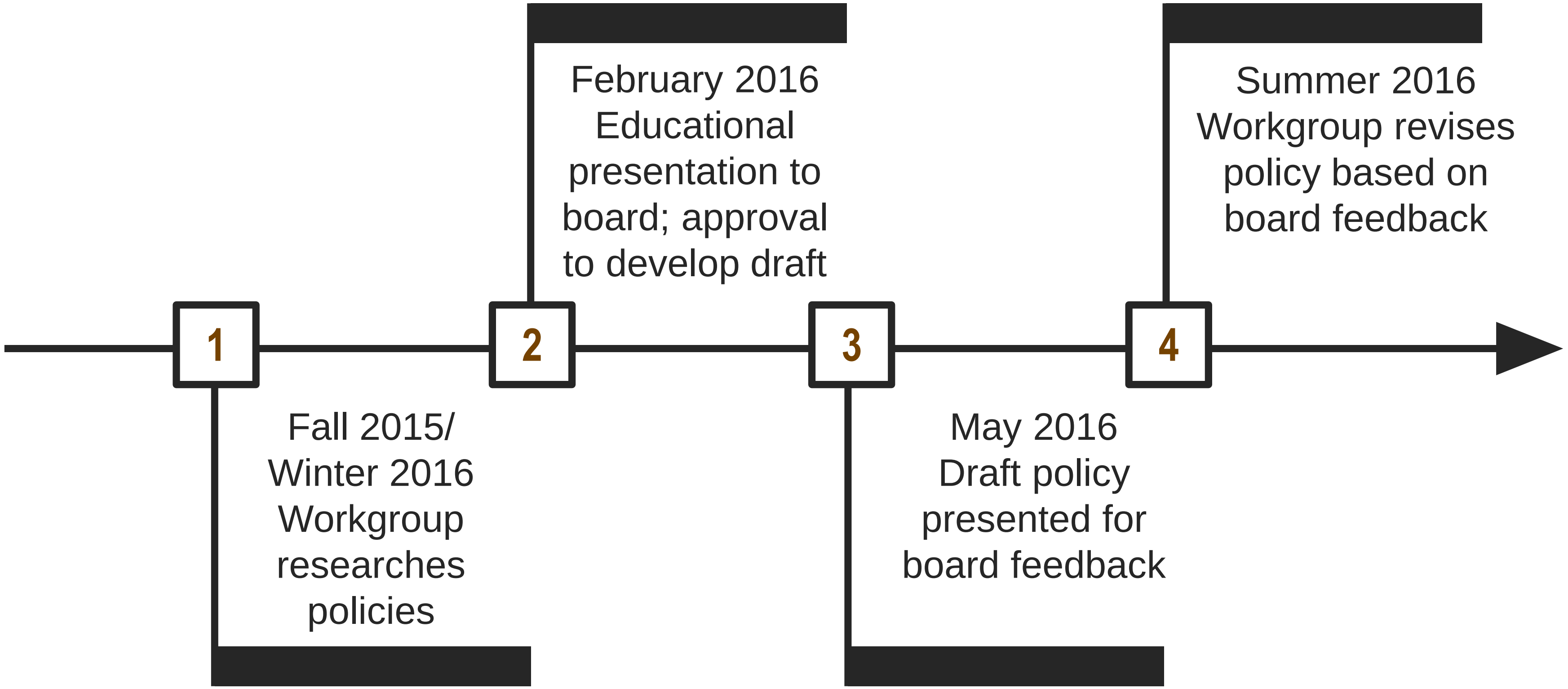
ERS

Develop a formal, comprehensive pension policy for ERS plans

- ☑ Where practical, implement best practices that make sense for our plans
- ☑ In the future, use policy to guide board and legislative discussions (such as developing Legislative Appropriations Requests)
- ☑ Update as needed
- ☑ Educate external stakeholders about funding policies and their practical implications

Pension Policy - Process and timelines

ERS



Proposed adoption:

August 2016 Board meeting

Agenda item 19, Meeting book dated May 17, 2016

Pension Policy Components

Policies cover key areas:

Actuarial cost method is used to allocate the total present value of future benefits over an employee's working career (normal cost/service cost).

Asset smoothing method is used to recognize gains or losses in pension assets over some period of time so as to reduce the effects of market volatility and stabilize contributions.

Amortization policy is the length of time and the structure selected for increasing or decreasing contributions to systematically eliminate any unfunded actuarial accrued liability or surplus.

Benefit enhancements – including cost-of-living adjustments (COLAs), 13th checks and other benefit increases. Ad-hoc, unfunded benefit enhancements from the 1980s through 2002 are part of the reason the system has accrued its current unfunded liabilities.

Potential Funding Policy Limitations

ERS

Fixed percent of payroll

Legislature sets contribution rate

Actuarially funded

Rate adjusted year-to-year

System sets contribution rate

Other Plans

Agenda item 19, Meeting book dated May 17, 2016

Exhibit A – Draft Policy Structure

ERS

- Introduction
- Funding Objective
- Funding Guidelines
- Key Terms
- Funding Methods
  - Actuarial Cost Method
  - Asset Smoothing
- Funding Period
- Benefits Enhancements
- Future Contribution Rate Changes
- Measures
- Monitoring Progress

Draft Policy Components

Key Sections

Policy Section	Method/Criteria in Policy	Comments
Actuarial Cost Method	Plans use entry age normal cost method (specifically a variation of ultimate entry age normal cost based on the cost of a new hire).	No change recommended
Asset Smoothing Method	20% of any market gain/loss recognized each year	No change recommended at this time, but method may be reconsidered during 2017-18 experience study
Funding Period	References existing statute 31-year standard, but offers two options to transition to a 20-year standard	Ideally select an option that better aligns with best practices (15-25 years)
Benefit Enhancements	Suggests a funding period standard of 20 years or less, plus a funded ratio of at least 90%. Guidelines for payment include either full payment or amortized over no more than 10 years.	If enhancements were routine, the costs would be built into the normal cost rate. Enhancements are ad-hoc for ERS administered plans.

Agenda item 19, Meeting book dated May 17, 2016

Actuarial Cost Method

- Allocates benefit costs between actuarial accrued liability (past service) and normal cost rate (future service)
- Many reasonable cost methods
- ERS uses Ultimate Entry Age Normal Cost Method
  - Reflects cost of a new hire
  - Put in place after the implementation of Group 2 benefits in 2009
- Not always considered a best practice, but it is acknowledged to be useful for plans funded on a fixed percent of payroll (as ERS administered plans are)
- Actuaries do not recommend a change to this method

Asset Smoothing Method

- Reduces volatility in year to year contributions needed
- Calculate expected value based on return assumption compared to actual value
- Two basic approaches – Fixed Base Method vs Adjustment Method
  - Fixed Based sets a defined period to recognize a gain/loss, and recognizes a portion of that each year (so for a 5-year smoothing, 1/5 recognized each year)
  - Adjustment sets a defined percent to recognize each year
- ERS uses Adjustment Method – 20% gain/loss recognized every year
  - Great for managing year-to-year volatility, but can take a long time to unwind from a major market event
  - Communication challenges with this method
- Actuaries do not recommend a change to this method at this time, but staff expect to review it during 2017-18 experience study and may suggest a change

Agenda item 19, Meeting book dated May 17, 2016

Funding Period

- Numbers of years needed to pay off unfunded liability
- Based on actuarially determined need
  - Includes normal cost and a portion to pay off unfunded liability within a defined period
- Open versus Closed Amortization
  - Open amortization – Contribution rate needed to meet funding period goal is reset each year
    - Current standard in Texas Government Code 811.006 (31-year standard)
  - Closed amortization – Contribution rate needed to meet funding period goal is calculated to meet a certain pay off date goal (theoretically funding period decreases by one year each year)
- Actuaries recommend that ERS work towards a best practice standard of less than 31 years (15 to 25).

Benefit Enhancements

- ERS administered plans are not designed or funded to provide automatic benefit enhancements
  - Past enhancements were ad-hoc
- Ideally, a retirement plan includes a way to address inflation and lost purchasing power
- Two features offset the lack of enhancements
  - The current multiplier of 2.3% is higher than average
  - The state workforce participates in Social Security, which increases the combined salary replacement rate
    - Since 1975, the Social Security Administration has granted Cost of Living Adjustments (COLAs) tied to the CPI; in only three years since has a COLA not been approved
- Draft policy suggests any future benefit enhancement should be paid through additional contributions rather than the balance of the trust

Questions?