EXECUTIVE SUMMARY: PENSION FUNDING

Benefits, whether offered by public or private sector employers, are an important tool in attracting and retaining a qualified workforce. Some benefits are mandatory (including Social Security and workers' compensation), while others are optional and provide that competitive incentive. Retirement systems an optional benefit are vital and changes can have a major impact on:

- An employee's retirement security,
- Unfunded liabilities,
- Costs, and
- The recruitment and retention of a viable State workforce.

Careful consideration is needed to assess and evaluate the State's retirement benefits, options for the future, and impact of potential changes to the state, taxpayers, the workforce and retirees.

RETIREMENT AND BENEFITS: An overview

In 1947, the State Legislature established a state employee retirement fund and corresponding retirement benefit design. In 1958, the state converted to a defined benefit plan. Today, the Texas Constitution requires that:

- Benefits are funded on an actuarially sound statistical calculation basis and that
- Both the State and the employees each contribute a minimum of 6% of payroll toward retirement.

DEFINED BENEFIT PLAN: How it works

The state pre-funds retirement benefits for its employees. Unlike government programs funded by general revenue, the ERS defined benefit plans are funded in advance through employer and employee contributions during the employees' working years. These contributions are invested and generate revenue for the long-term funding of retirement benefits.

The Trust is comprised mostly of income generated from long-term investments; the remainder is from employee and employer contributions. This model lowers the cost to the employers while it grows the Trust value.

A 100% funding level means that a defined benefit plan has an equal balance between current and future assets and liabilities. A balanced plan is expected to have sufficient investment earnings and contributions to equal the benefits being earned and paid.

It looks like this:

INVESTMENT EARNINGS + CONTRIBUTIONS = BENEFITS + EXPENSES

ERS
EMPLOYEES RETIREMENT SYSTEM OF TEXAS

Investments are the largest part of the equation, yet the other three components are just as significant and essential to the long-term sustainability of a retirement plan.

Investments make up about two-thirds of the trust's market value. When the investments experience short-term losses and gains, it has a big impact and the impact is quickly apparent. Sustained long-term investment losses would be devastating to the plan. Fortunately, that has not been the case as ERS investments have earned 8.5% over the past 30 year period.

State and member **contributions** make up the other one-third of the trust value. Since this is a smaller part of the revenue, insufficient contributions have a less immediate and impact. Yet, over the course of time, contribution shortfalls can prevent a plan from becoming actuarially sound, eliminating its ability to weather the years when the market (investments) are down, and making it more expensive to make up the deficit funding.

Even though a plan hits its investment goals, if contributions are indefinitely insufficient, the plan will eventually run out of money. For the ERS plan, contributions have not fulfilled its role in 17 of the last 20 years.

Recent **benefit** adjustments have lowered the cost of the benefits current employees earn each year, or the normal cost to 11.57% of payroll. Current contributions from the state and employees are paying more than the cost of the benefits being earned by current employees, so the benefit structure is in line with contributions.

With $0.78 for every dollar needed to pay benefits, the ERS Trust is not balanced. Why?

- Contributions are enough to pay the cost of benefits that new employees earn, but not enough to pay off benefits earned in the past, before changes were implemented
- Fewer workers paying in, more retirees, plan design, longer lifespans
- Investment losses

As of the August 31, 2013 ERS actuarial valuation results, the difference between what is owed and what is owned unfunded accrued liability, what is paid back at a later date is $7.2 billion. This balance is growing and is expected to be $8 billion by 2015.

REAL-LIFE IMPLICATIONS

If you are a 40-year-old employee with 10 years of service, you are able to retire in 15 years at age 55. However, the Trust Fund is currently projected to run out of money when you reach 78.

PLAN RECOVERY: A sound fund

It's important to note that there are options and time is a critical component to balance the fund. There isn't one solution to this issue. A combination of approaches can bring results.

Increase revenues and/or decrease costs

REVENUE OPTIONS INCLUDE:

- One-time lump sum cash contribution
- Increase payroll contributions from state and/or members
- Find alternative source of revenue, such as dedicated funding or bond revenue

Revenue generators could include pension obligation bonds, a one-time revenue source and/or an ongoing alternative source.

If using POBs, funding source(s) repay the bonds. Alternative revenue could include dedicating a revenue source to pay down the unfunded liability or directing future-lapsed general revenue to ERS.

WHAT ARE PENSION OBLIGATION BONDS?

Pension obligation bonds are issued by a state or local government to pay its obligation to the pension system. During periods of low interest rates, POBs have been used as effective tools to increase pension fund investable assets and fund the unfunded liability (debt to be paid in the future, similar to how you use a credit card).

Since 1986, the POB market has a total issuance of $75.21 billion, according to Thomson Financial. Pension revenue bonds also could be issued, with much of the same benefits as POBs. POBs require a dedicated revenue stream.

BENEFIT OPTIONS INCLUDE:

MODIFY BENEFITS TO REDUCE THEIR COSTS

CHANGE WORKFORCE OR ELIGIBILITY POLICY SO PEOPLE ARE REQUIRED TO WORK LONGER BEFORE RECEIVING RETIREMENT BENEFITS

APPLY BENEFIT CHANGES (REDUCTIONS) TO MORE EMPLOYEES

FURTHER REDUCE BENEFITS FOR NEW HIRES

ERS, TRS: Different plans, different funding needs

Demographics and growth, benefit costs, and contribution rates are impacting the financial health of both ERS and the Teacher Retirement System of Texas (TRS).

The declining workforce, added cost to support Texas law enforcement and custodial officers (LECOS), and ongoing inadequate contribution rates put ERS in a very different situation than that of TRS. Teachers tend to start younger, have a growing population, and many leave without retiring all of which helps make the TRS plan more sound.

Knowing this, ERS and TRS require different funding models.

ERS, LECOs: True cost of benefits

Law enforcement and custodial officers (LECO) have higher cost benefits that increase the cost for ERS. The ERS Trust fund pays for 80% of an officer's benefit.

The legislature has asked ERS to account and report the cost for LECO benefits separately, in the interest of increased transparency and to show the true cost of the benefits.

New reporting standards will show higher pension liabilities for Texas

New Governmental Accounting Standards Board (GASB) standards relating to accounting and reporting for pensions will change the calculation and presentation of pension liabilities. The new standards will increase the reported unfunded pension liability and make it a part of the state's financial statements. According to GASB, the regulations are not meant to be used to determine a plan's funding requirements.

ERS will report the numbers in the ERS Comprehensive Annual Financial Report issued in November 2014. The Texas Comptroller of Public Accounts is required to report it in the State of Texas financial report issued in February 2016. The State of Texas currently reports the difference between the actuarially required contribution and the actual contribution as a liability (the annual shortfall). Under the new standards, the financial statements will report the full amount of the Net Pension Liability.

The new standards base funding requirements on the design and policies of each plan shorten the amortization periods for actuarial changes and use lower discount rates on any unfunded liabilities.

FUNDING EFFORTS: Past and future

The Texas Legislature made proactive changes in 2009 to rein in the cost of benefits being earned and to lower early retirement rates. And in 2013, the Texas Legislature again tried to further remedy the growing concern over benefits and, specifically, how the retirement plan is funded and offered. The bill, as originally drafted, changed considerably through the legislative process. Unfortunately, neither effort had significant impact on the program or its funding.

Time is of the essence. There is work to be done to ensure the State is able to meet its long-term obligations with a full understanding of the short- and long-term effects on the state, its workforce and the citizens that rely on their services.

With the 2015 Texas Legislature approaching, it is imperative all parties are fully aware of the fund's intent, status, and need for action.