



# INTERIM REPORT

*to the 85<sup>th</sup> Texas Legislature*



HOUSE COMMITTEE ON  
PENSIONS



DECEMBER 2016

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**HOUSE COMMITTEE ON PENSIONS  
TEXAS HOUSE OF REPRESENTATIVES  
INTERIM REPORT 2016**

**A REPORT TO THE  
HOUSE OF REPRESENTATIVES  
85TH TEXAS LEGISLATURE**

**DAN FLYNN  
CHAIRMAN**

**COMMITTEE CLERK  
KELLI LINZA**

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Committee On  
Pensions

December 5, 2016

Dan Flynn  
Chairman

P.O. Box 2910  
Austin, Texas 78768-2910


The Honorable Joe Straus  
Speaker, Texas House of Representatives  
Members of the Texas House of Representatives  
Texas State Capitol, Rm. 2W.13  
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

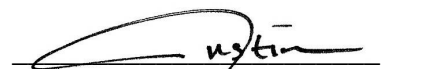
The Committee on Pensions of the Eighty-fourth Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Eighty-fifth Legislature.

Respectfully submitted,

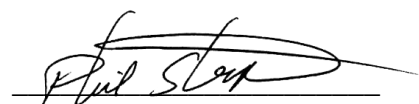
  
Chairman Dan Flynn

  
Vice Chairman Roberto Alonzo

  
Representative Ana Hernandez

  
Representative Justin Rodriguez

  
Representative Dennis Paul

  
Representative Phil Stephenson

  
Representative Stephanie Klick

Vice-Chairman Roberto Alonzo

Members: Representative Ana Hernandez, Representative Justin Rodriguez, Representative Dennis Paul, Representative Phil Stephenson,  
Representative Stephanie Klick

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## TABLE OF CONTENTS

PENSIONS .....	4
I. Executive Summary.....	4
II. Committee Composition and Public Hearings .....	4
III. Discussion of Charges.....	5
Charge 1: The Committee was tasked to study the impact that fluctuations in global financial markets have had on public pension funds and to analyze assumed rates of return on investments, structures among asset classes, long-term and shorter-term investment goals, and make appropriate recommendations to ensure the investment structure of public pension funds are meeting fiduciary responsibilities.....	5
Charge 2: The Committee was asked to examine Texas pension funds' compliance with Governmental Accounting Standards Board (GASB) Financial Reporting Statements 67 and 68, and identify the effect the reporting requirements are having on the state's pension systems.....	7
Charge 3: The Committee was asked to examine the immediate and long-term fiscal impact to the state of the unfunded liabilities for the Law Enforcement and Custodial Officer Supplemental Retirement Fund (LECOS) as part of the Employees Retirement System of Texas (ERS).....	7
Charge 4: The Committee was asked to examine the fiscal and policy impacts of structural reforms that would increase state public pension plans' ability to achieve and maintain actuarial soundness. Evaluate the feasibility, costs, and benefits of utilizing one-time funding increases to reduce or eliminate unfunded liabilities. ....	7
Charge 5: The Committee was asked to evaluate the investment performance benchmarks utilized by the state's pension funds and the impact portfolio diversification and short- and long-term market assumptions have had on achieving expected investment returns. Analyze the fee structure and investment strategy for various investment classes to ensure the costs are reasonable and competitive versus other large public and private pension trust funds. ...	8
Charge 6: The Committee was asked to conduct legislative oversight and monitoring of the agencies and programs under the committee's jurisdiction and the implementing of relevant legislation passed by the 84th Legislature. In conducting this oversight, the committee was asked to consider any reforms to state agencies to make them more responsive to Texas taxpayers and citizens, to identify issues regarding the agency or its governance that may be appropriate to investigate/improve/remedy/eliminate, to determine whether an agency is operating in a transparent and efficient manner, and to identify opportunities to streamline programs and services while maintaining the mission of the agency and its programs. ....	13
IV. Recommendations.....	15

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# PENSIONS

## I. Executive Summary

The Texas Legislature is charged with oversight of pensions under state statute. The jobs included in pension plans are diverse and include policeman, fireman, teachers, municipal employees, and many others. Based on current available data, there are more than 90 pension plans with over 200 billion dollars state wide in assets. In addition, these plans have approximately 60 billion in unfunded liabilities for a funded ratio of around 80%.

Some of the plans that are cause for major concern are those with infinite and long amortization periods or those that are in danger of heading towards an infinite or long amortization. However, all plans have consistently suffered from an aging demographic of its members, an overreliance on automatic colas, unstable markets that can no longer guarantee a high rate of return, sometimes too generous benefits, and the multiple processes including city/pension plan interaction that makes for a sometimes tumultuous relationship. People are living longer and, as an example, TRS has over one hundred members over the age of 100. Complicating all plans is the fact that current plans were never designed for members to receive benefits for longer periods than they were actually employed.

As a result, the Pensions Committee was tasked with analyzing the pension plans and developing solutions because if nothing is done, plans will quickly become unsustainable, meaning they will run out of money to pay current retirees and recruit new ones. This situation is complicated by a call for a change in plans to direct contribution from directed benefit and also by the need for more active local control. All the groups understand they need the political will from the members, both legislatures, and their administrations to provide long term sustainability to the plans.

## II. Committee Composition and Public Hearings

The House Committee on Pensions is composed of 7 members chosen by the Speaker of the House. Representative Dan Flynn is Chair, Representative Roberto Alonzo is Vice Chair, and the other members are Representative Dennis Paul, Representative Justin Rodriguez, Representative Ana Hernandez, Representative Phil Stephenson, and Representative Stephanie Klick.

The Committee conducted 2016 public hearings on March 30th, April 13th, June 13th and September 29th to provide a forum for discussion regarding interim charges and gather information about concerns on behalf of the members, cities, plans, and multiple groups interested in pensions. The Committee will have its last hearing on November 14th, 2016 to discuss Interim charge 3 concerning LECOS.

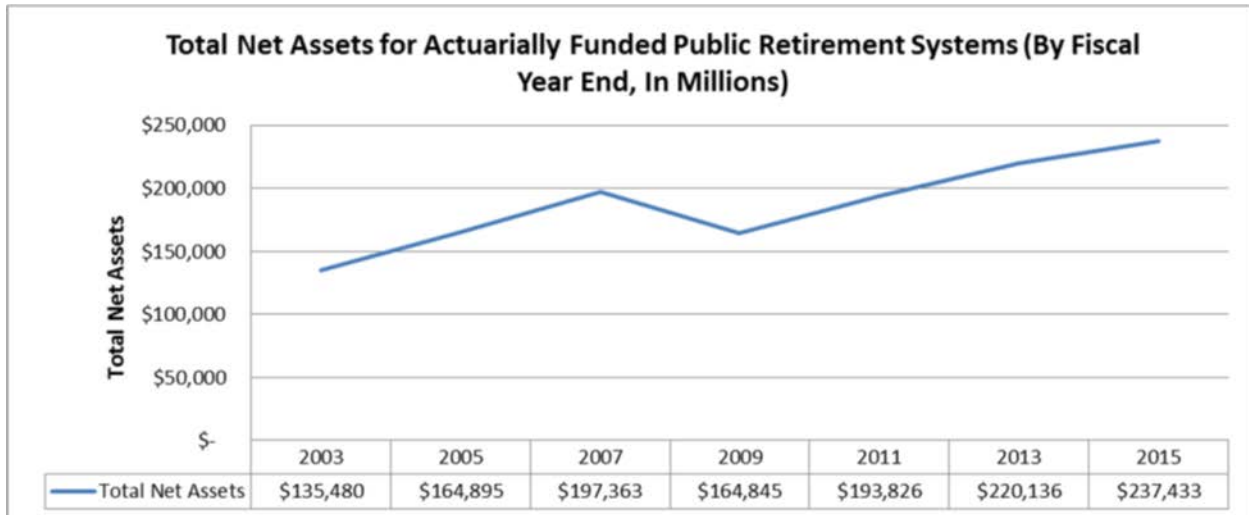
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### III. Discussion of Charges

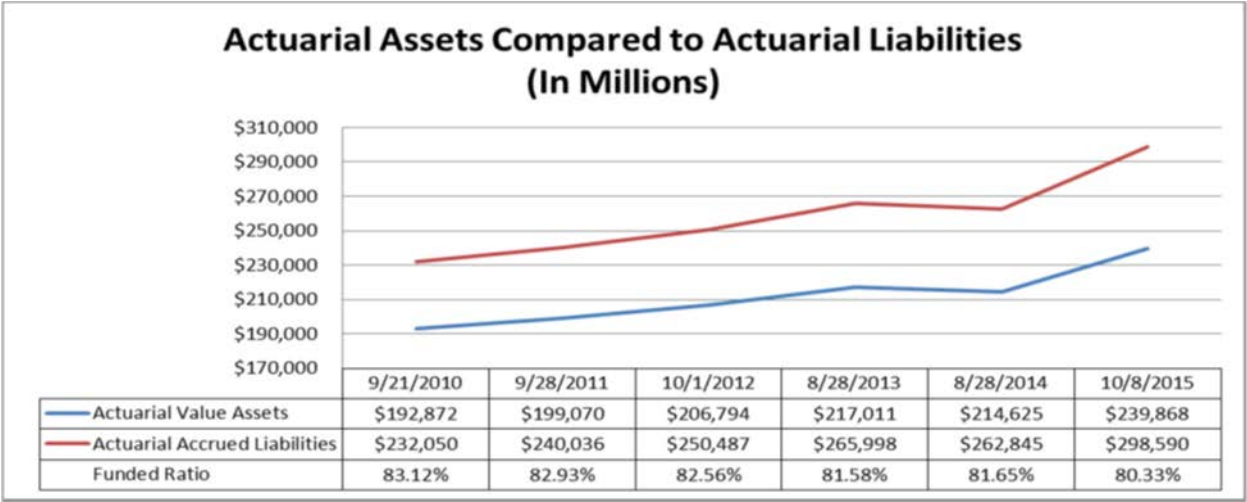
*Charge 1: The Committee was tasked to study the impact that fluctuations in global financial markets have had on public pension funds and to analyze assumed rates of return on investments, structures among asset classes, long-term and shorter-term investment goals, and make appropriate recommendations to ensure the investment structure of public pension funds are meeting fiduciary responsibilities.*

Of Texas's 93 plans, 21 have amortization periods of greater than 40 years and 37 have amortization periods less than 25 years. Direct Benefit (DB) plans, on the aggregate, are funded at 80% using an actuarial value of assets and 78% using a market value of assets. Since the market low in 2009, the total net assets of the 93 systems increased from \$165 billion to approximately \$237 billion as of February 2016. The average funded ratio using an actuarial value of assets has decreased from 83.12% in 2010 to 80.33% in 2015. Retirement systems are expected to report weak or flat investment return performance for 2015.

Overall, systems have made steady investment gains since 2009; the total net assets reported for 2015 are significantly greater than the 2007 highs.



In the last six years, the variance between the actuarial value of assets and actuarial accrued liability has increased, from almost \$40 billion in 2010 to just under \$60 billion in 2015.



The average net investment returns for retirement systems exceeded 8 percent for the 3-year average returns but fell below 8 percent for the 10-year average returns.

Average Returns by Plan Type (2014 Investment Returns and Assumptions Report)			
Plan Type	1 Year net	3 Year net	10 Year net
Statewide	10.83%	10.97%	6.98%
Municipal	8.34%	10.03%	6.75%
TLFFRA	5.05%	9.89%	5.73%
Chapter 810	7.42%	10.75%	6.13%
Total	7.91%	10.41%	6.40%

Retirement systems in Texas have reduced their rate or return assumptions as a response to predicted market projections and this trend of reduced rate of returns is expected to continue. Lowering this assumed rate of return will increase recommended contributions in the short term. If a retirement system receives the higher contribution, the actuarial soundness will not be affected in the long term.

Investment performance data from 2015 shows weak returns. While short-term fluctuations in global financial markets can have an impact on current asset values, they should not impact the long-term rate of return assumption for invested assets. However, systems should regularly

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review their investment return and inflation assumptions to ensure those assumptions align with the systems' investment strategy, asset allocation, and risk tolerance.

*Charge 2: The Committee was asked to examine Texas pension funds' compliance with Governmental Accounting Standards Board (GASB) Financial Reporting Statements 67 and 68, and identify the effect the reporting requirements are having on the state's pension systems.*

There was no hearing specifically on charge number 2 but the GASB Financial Reporting Statements 67 and 68 and details concerning compliance and effects were discussed at the April, June and September hearings.

State law requires public retirement systems in Texas to comply with GASB 67 disclosure standards. Currently, a majority of the plans are compliant. There are a couple plans that are struggling but are working with PRB towards compliance.

The effects of the updated GASB requirements vary among the plans but the plan sponsors, under GASB 68, are now required to report Net Pension Liabilities (NPL) for their retirement systems, which are calculated on market value basis, on their balance sheets. This requirement for plan sponsors to report higher liabilities on their balance sheets has created more accountability both for the plans and their sponsors. Having to report a higher NPL on balance sheet can result in a positive outcome where a system facing funding shortfall would be taken more seriously by its sponsor.

The new accounting disclosure requirements can be expensive to for smaller plans to meet who may have to purchase additional hours from their auditors to become compliant. But these disclosure requirements bolster transparency and are helpful for regulators and review boards as they allow more data to be collected and distributed to legislators.

*Charge 3: The Committee was asked to examine the immediate and long-term fiscal impact to the state of the unfunded liabilities for the Law Enforcement and Custodial Officer Supplemental Retirement Fund (LECOS) as part of the Employees Retirement System of Texas (ERS).*

The Committee is set to have a hearing on Interim Charge 3 on November 14th, 2016.

*Charge 4: The Committee was asked to examine the fiscal and policy impacts of structural reforms that would increase state public pension plans' ability to achieve and maintain actuarial soundness. Evaluate the feasibility, costs, and benefits of utilizing one-time funding increases to reduce or eliminate unfunded liabilities.*

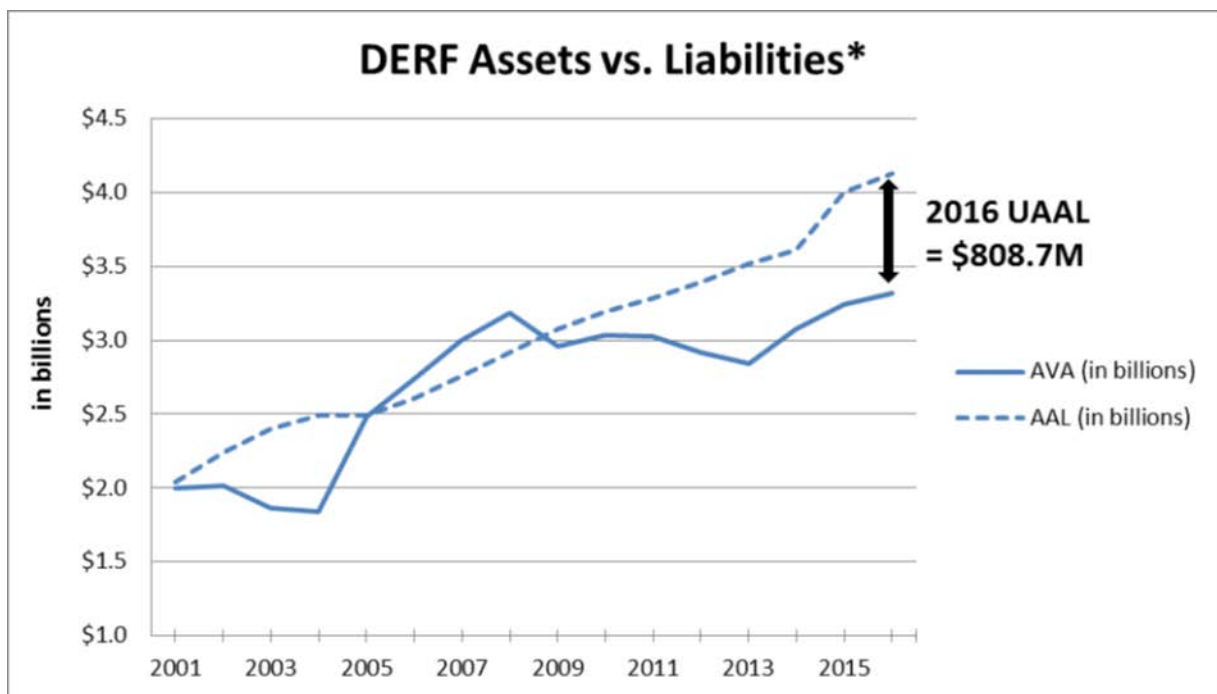
The Committee convened in Houston to use the city and pension plans as an example for how to ensure fiscally responsible and effective structural reforms that would increase state public pension plans' ability to achieve and maintain actuarial soundness. The Committee evaluated the policy impact of obligated funds not paid by the city of Houston. The Committee also evaluated the idea that COLAS should be halted until such time as the Pensions are actuarial sound. The Committee also heard about the feasibility of adopting minimum funding standards and requirements to allow the benefits and shortfalls of plans to be addressed.

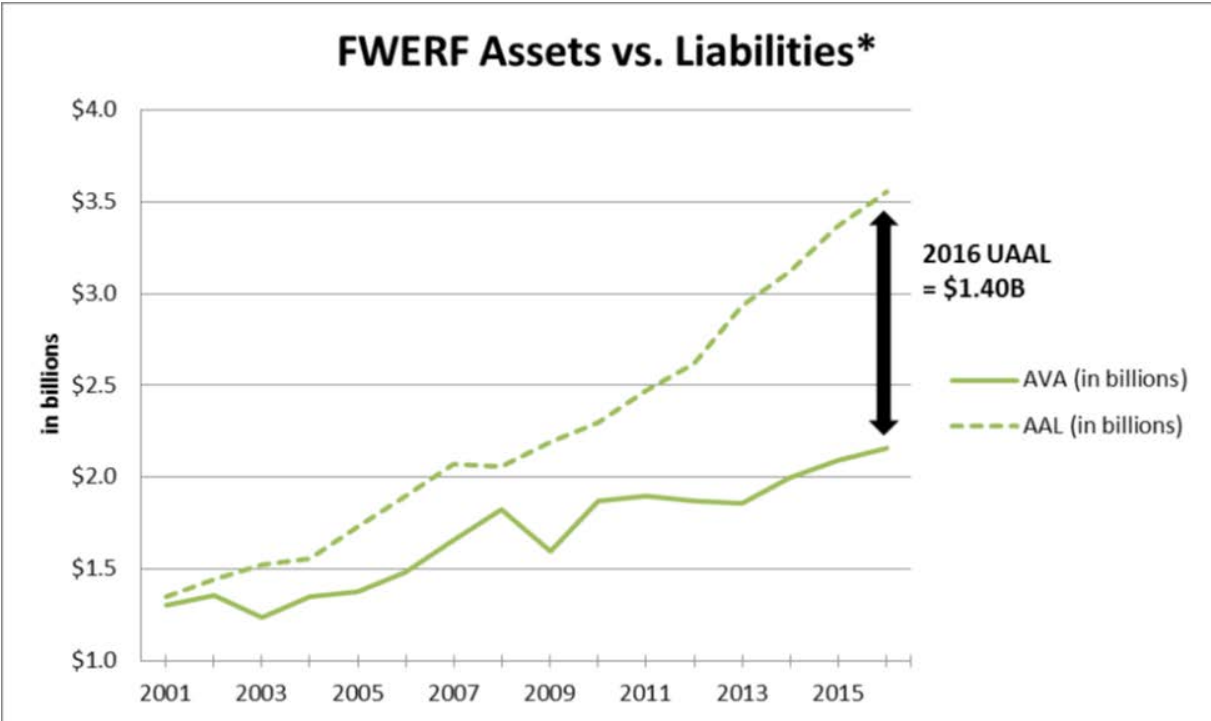
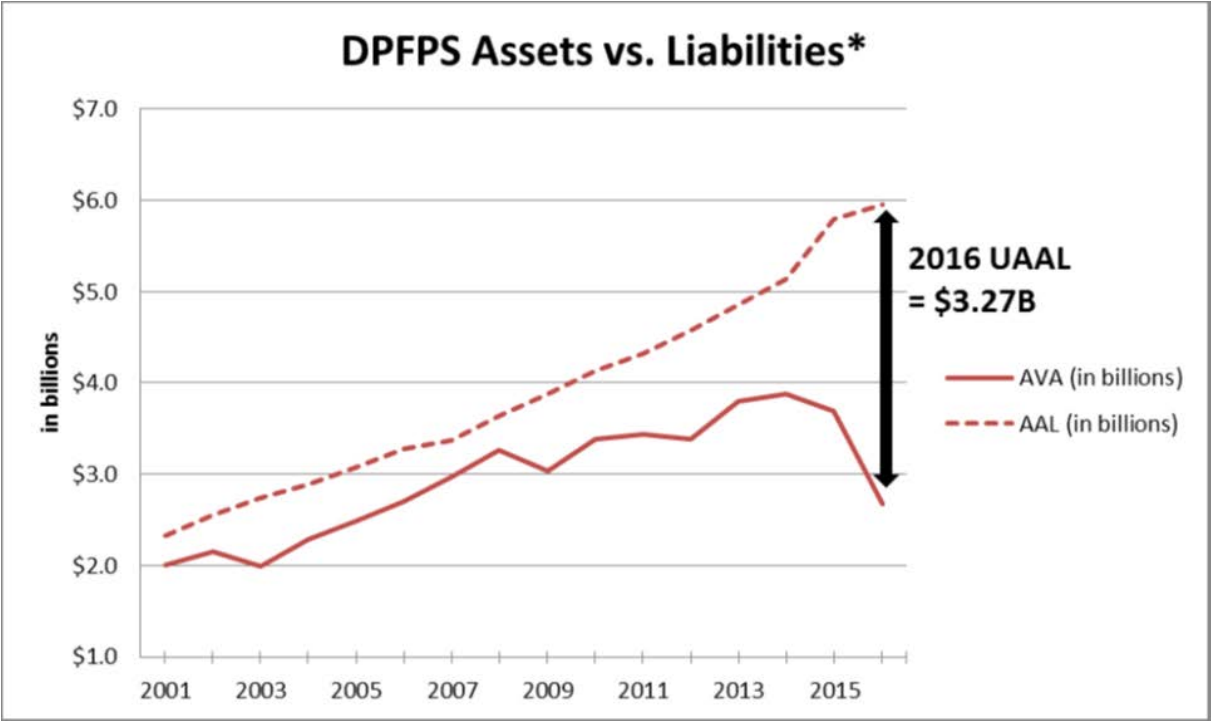


It was determined that a one-time funding increase to reduce or eliminate unfunded liabilities may work in a few pension plans but overall, this was not a preferred method of reducing unfunded liabilities.

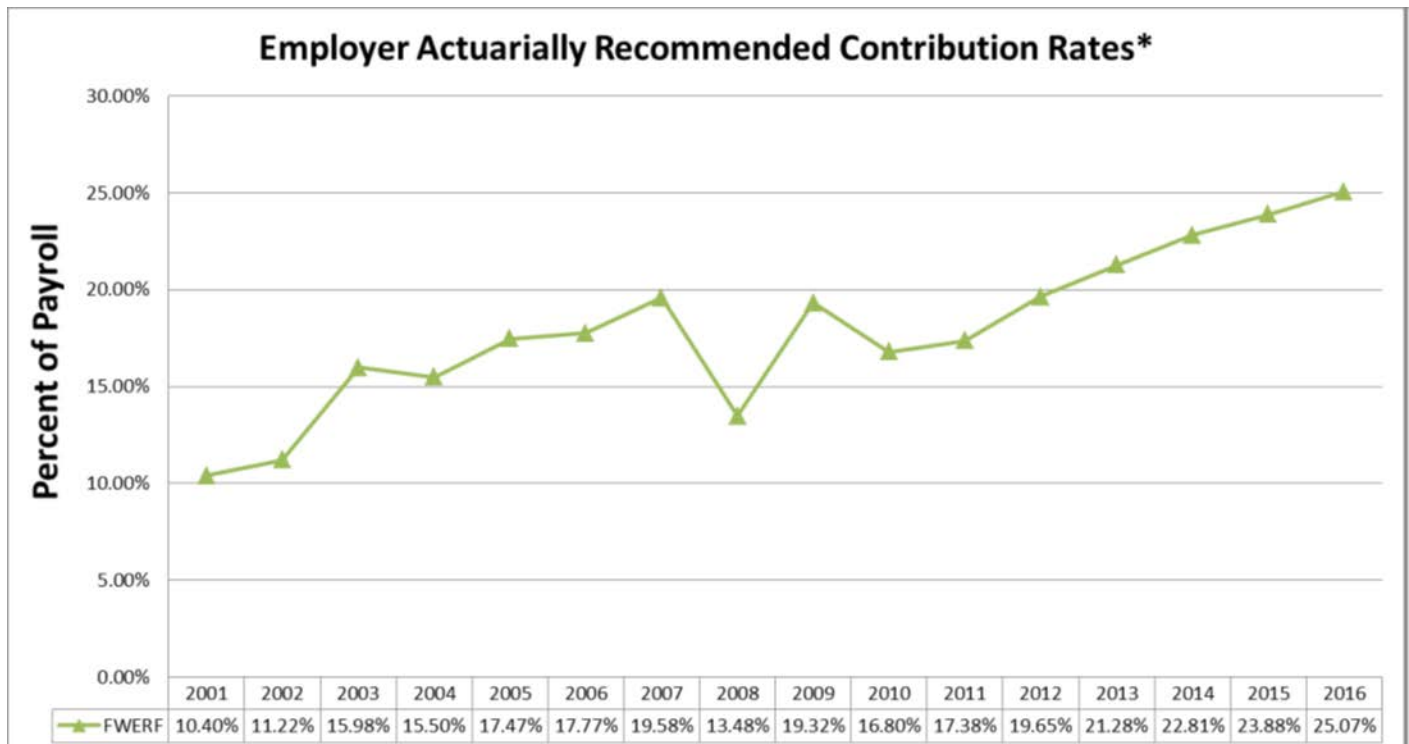
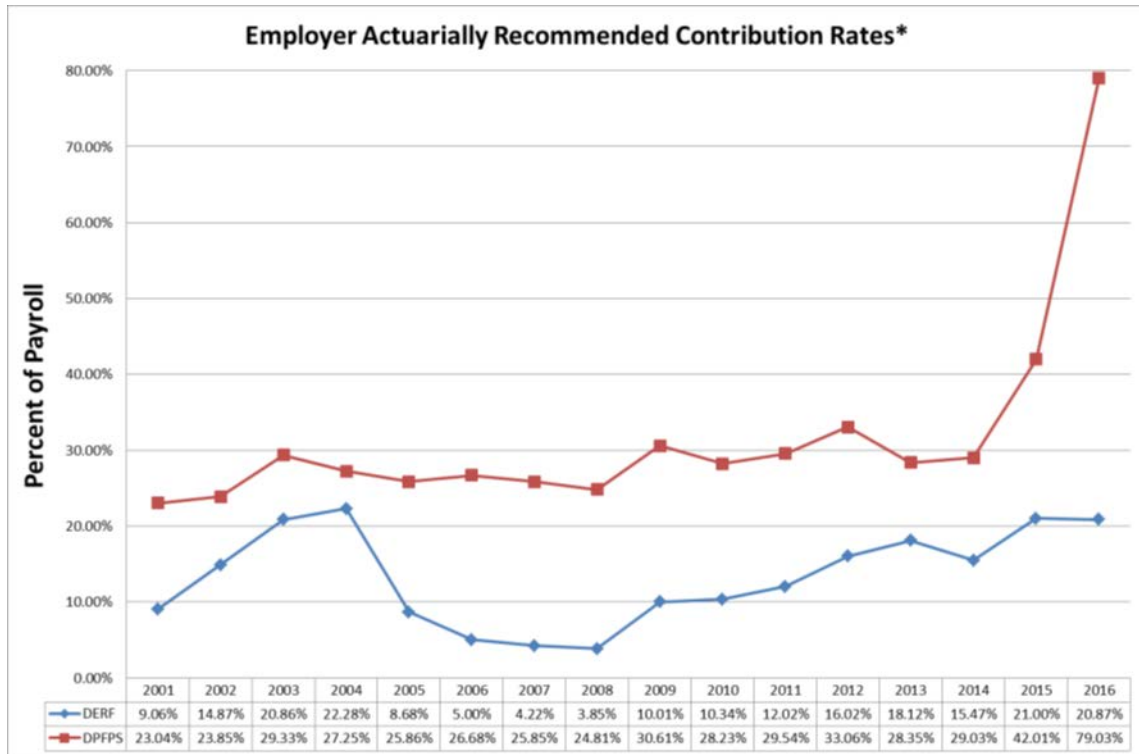
*Charge 5: The Committee was asked to evaluate the investment performance benchmarks utilized by the state's pension funds and the impact portfolio diversification and short- and long-term market assumptions have had on achieving expected investment returns. Analyze the fee structure and investment strategy for various investment classes to ensure the costs are reasonable and competitive versus other large public and private pension trust funds.*

There is a growing change in asset valuation based on market trends. Therefore, it is important that the assets are valued based on current market and expectations of return are more realistic, achievable and sustainable.



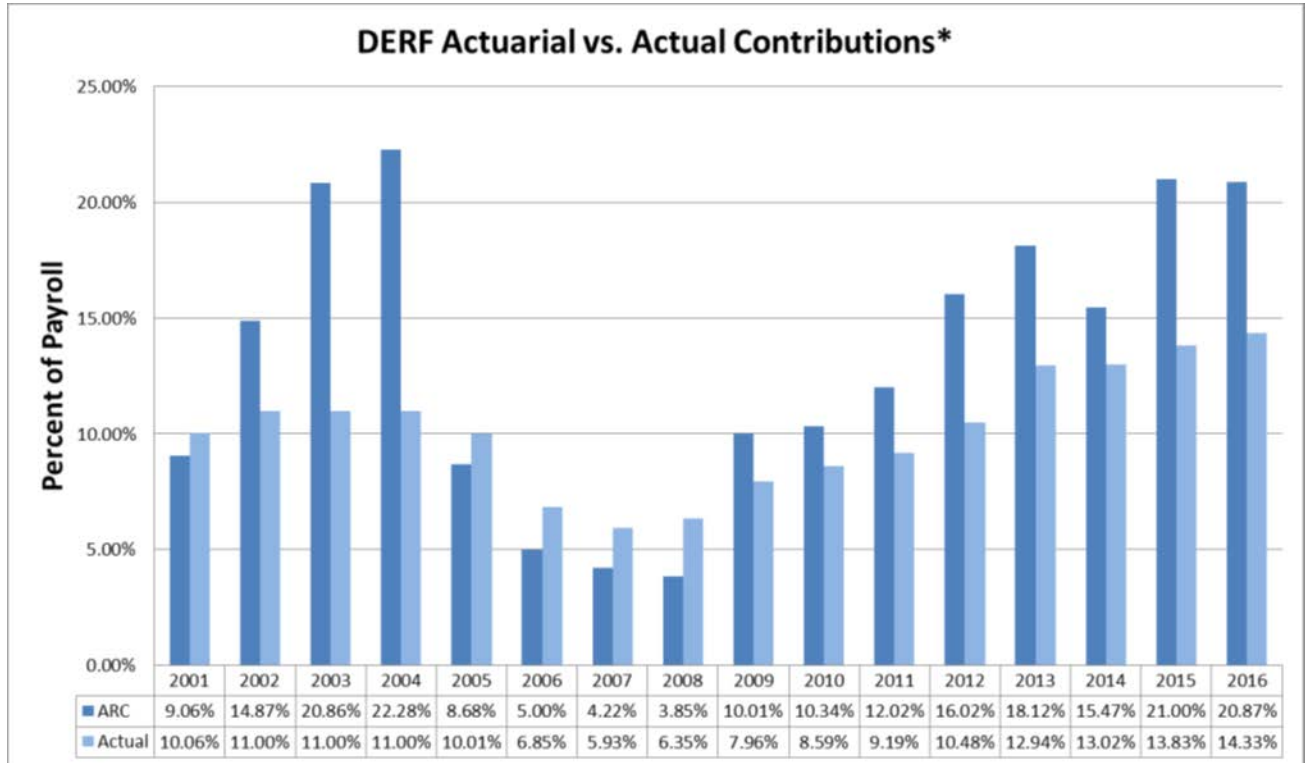


The contribution rates have not met or exceeded the actuarially recommended contribution rates for the Dallas Employee Retirement Fund and Fort Worth. This has been the result of statutory issues as well as budgets and inability to coordinate and prioritize contributions to save the plans. There was not enough money put into plan years ago and every year since. Therefore the deficit is making it so the plan is unsustainable.

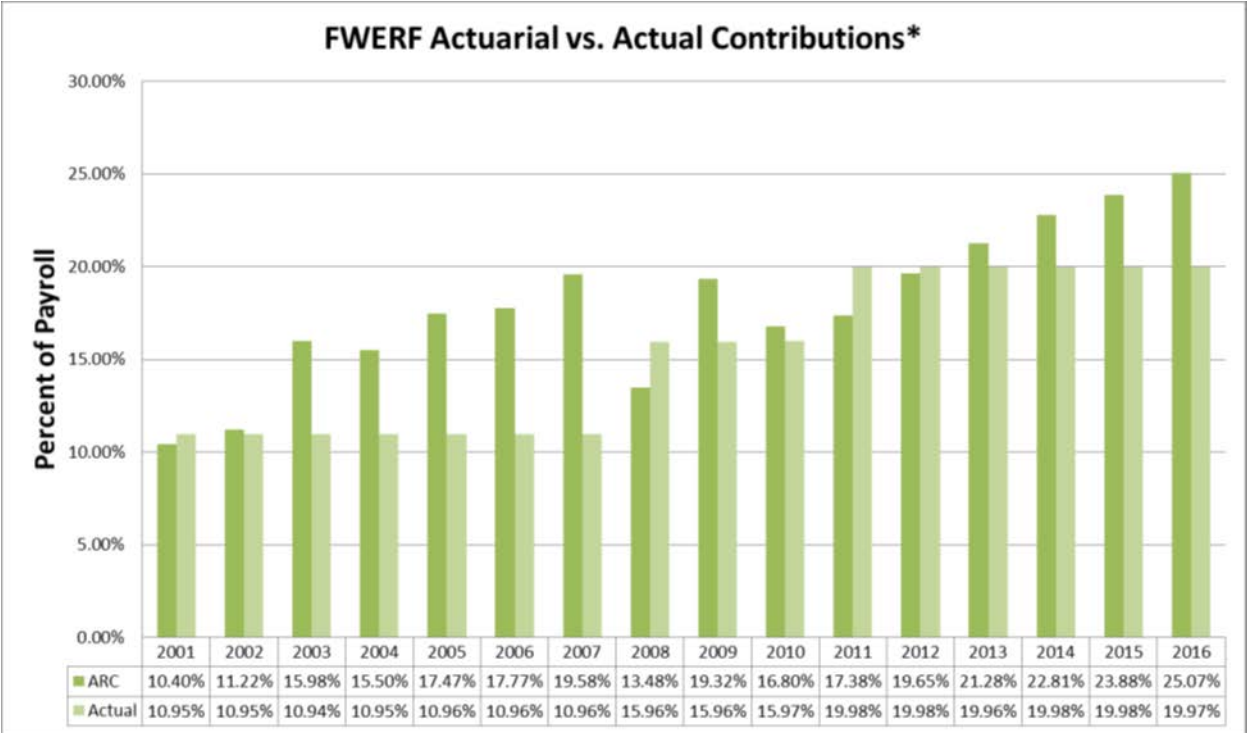
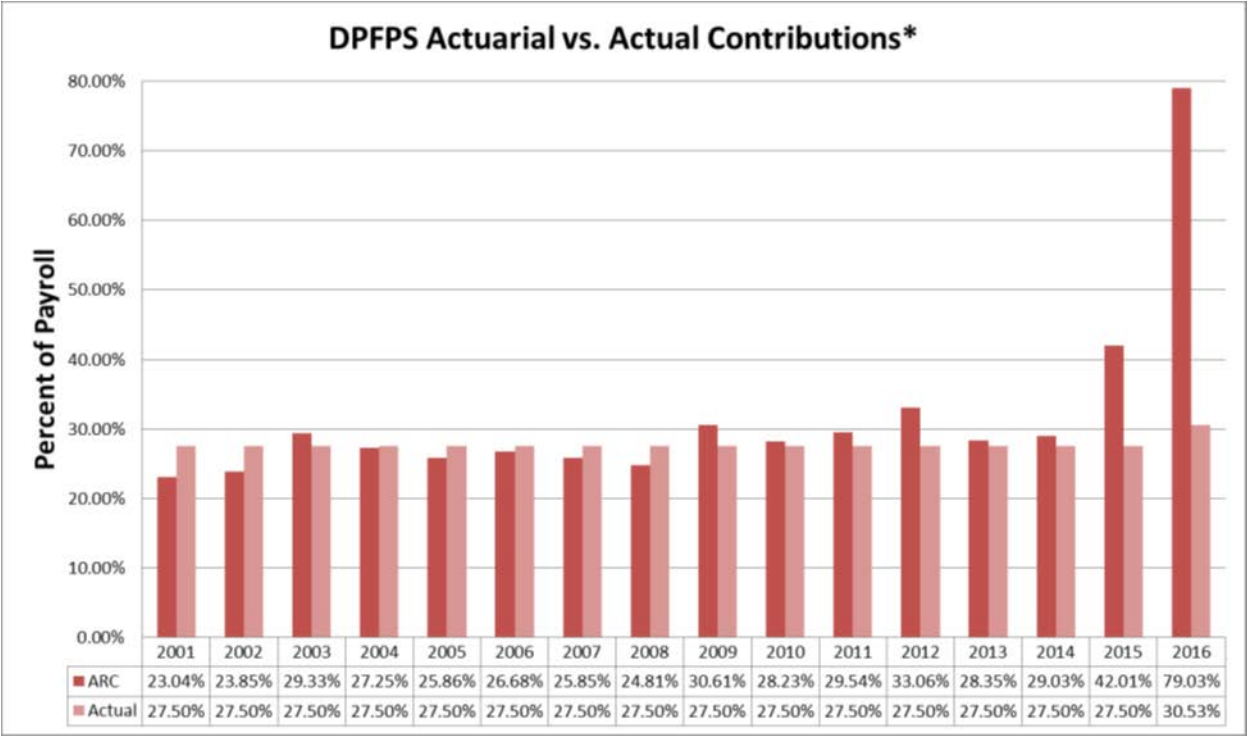


Actual contributions well short of the recommended actuarial contributions exacerbated a situation where markets fluctuated and the rates of return plummeted. Part of the deficit would have been mitigated if in fact, years ago starting at around 2002, the plan would have made the

contributions necessary to have been considered in the future equations and would have taken advantage of a rise in the market in early 2000's. Now the plan suffers because of the lack of having those dollars within its asset classes.



The actuarial vs. Actual contributions for DPFPS were comparable from 2001 until 2014 with missing spikes in 2009-2014 time frame. In 2015/2016, actual contributions lagged behind actuarially suggested contributions. As a result of restatement (significant write downs in real estate assets) of several years' worth of financial statements that caused the plan itself to lose actuarial soundness and is currently considered indefinite. This is further complicated by a run on assets being withdrawn from the overgenerous DROP program and some of the most generous cost of living increases in the country. If left unchecked, the trend will cause the plan to be insolvent in approximately 2030 and current proposed plan amendments would only bring the plan in line until 2041-none of which would provide a level of actuarial soundness.



The Fort Worth Employees Retirement Fund's actuarial versus actual contribution trends shows a definite lack of contributions from 2003 to the 2009 time frame, contributing to a shortfall of over a billion dollars. This is representative of many plans who failed to make sound actuarial contributions and relied too much on the hopes that the market conditions would allow the

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shortfalls to be compensated for. The historical lack of parity between the actuarial versus actual contributions leaves all plans vulnerable to downturns in the market, the inability to have funds to invest with opportunity, and leaves the plans vulnerable to administrative issues such as changes in GASB and criminal activity such as occurred with the Dallas plan where a required restatement of asset valuations caused the plan to be actuarially unsound and on a path to insolvency.

*Charge 6: The Committee was asked to conduct legislative oversight and monitoring of the agencies and programs under the committee's jurisdiction and the implementing of relevant legislation passed by the 84th Legislature. In conducting this oversight, the committee was asked to consider any reforms to state agencies to make them more responsive to Texas taxpayers and citizens, to identify issues regarding the agency or its governance that may be appropriate to investigate/improve/remedy/eliminate, to determine whether an agency is operating in a transparent and efficient manner, and to identify opportunities to streamline programs and services while maintaining the mission of the agency and its programs.*

The 84th Legislature passed H.B. 3310 that made important disclosure and reporting requirement changes for retirement systems to help improve and maintain their actuarial and financial health. Three main provisions under the new law are:

**Funding Soundness Restoration Plan (FSRP)** - If a retirement system receives several consecutive valuations showing that the system's amortization period exceeds 40 years, the system's governing body and sponsoring entity must formulate a funding soundness restoration plan and submit the plan to the PRB. Systems and their sponsors currently subject to the requirement have until November 1, 2016 to formulate the first plan.

**Recommended Contribution** - An actuarial valuation of a public retirement system must include a recommended contribution rate to achieve and maintain an amortization period that does not exceed 30 years.

**Actuarial Experience Study** - Public retirement systems that have assets of at least \$100 million are required to conduct an actuarial experience study once every five years and to submit that study to the PRB. The first such study would be conducted by September 1, 2016 or within 5 years of the previous study (for systems that have conducted a study after 8/31/2011).

State law and the PRB Guidelines for Actuarial Soundness establish a maximum amortization period of not more than 40 years. The PRB Guidelines further provide a recommended amortization period of 15 to 25 years.

Retirement System Amortization Periods		
Amortization Period	Number of Plans	Percent of Total
Greater than 40	21	23%
Between 25 & 40	35	37%
Less than 25	37	40%

The total unfunded actuarial accrued liability (UAAL) for Texas public retirement systems is approximately \$60 billion, with an actuarial value of assets (AVA) of approximately \$242 billion.

Retirement System Funded Ratios		
Funded Ratio	Number of Plans	Percent of Total
Greater than 80%	26	28%
Between 60 & 80%	45	48%
Less than 60%	22	24%

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## **IV. Recommendations**

It is the Committee's recommendation that all pension plans work with their respective cities in order to negotiate and come to an agreement that works for both the members of the funds and the taxpaying citizens of those cities while it is still financially feasible to do so. "IOU's" and "promises" cannot be used in place of assets to determine solvency. It is the Committee's recommendation that missed payments and contributions can be made up through use of appropriate instruments such as pension obligation bonds and/or one time payments. The Committee will not recommend one time funding increases from the State as a way to boost historic shortfalls as this is both impractical and local considerations and changes need to be enforced before that discussion can take place.

It is imperative that cities understand that if they do not act now, the cost to repair plans will be beyond the means of any city (large or small) to sustain any of the current pension plans. If a suitable agreement is unable to be reached, severe actions will need to be taken to ensure the financial sustainability of pension plans. These actions would include some or all of the following measures: Freezing cost of living increases until a time where the plan is actuarially sound, reducing benefits, increasing contributions, eliminating or drastically changing DROP programs, and/or requiring cities to make up missed contributions and freeze all city pay until such a time as the plans are actuarial sound. The Committee does recommend that a combination of pension obligation bonds and excess bonding capacity be used to make up for historic shortfalls in actuarially recommended contributions. It is crucial that shared sacrifice be shared between cities and plans handling pension obligations.

The pension plans themselves cannot be fixed by simply changing the type of plans. The problems that were uncovered and addressed during the interim committee hearings do not mean it is suitable or desirable to switch plans from defined benefit to defined contribution without more knowledge and understanding what that would do to current membership, current employees or future generations of employees.