OKLAHOMA PENSION SYSTEMS

Distributed By Keep Oklahoma’s Promises, a coalition of educators, public safety professionals and concerned citizens.
## A House in Order

<table>
<thead>
<tr>
<th>Plan</th>
<th>Actuarial Value of Assets (in millions)</th>
<th>Actuarial Accrued Liability (in millions)</th>
<th>Funded Status as of 7/1/2016</th>
<th>Funded Status as of 7/1/2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Teachers</td>
<td>$14,578</td>
<td>$22,193</td>
<td>65.7%</td>
<td>66.6%</td>
</tr>
<tr>
<td>Public Employees (PERS)</td>
<td>$8,791</td>
<td>$9,428</td>
<td>93.2%</td>
<td>93.6%</td>
</tr>
<tr>
<td>Firefighters</td>
<td>$2,293</td>
<td>$3,477</td>
<td>65.9%</td>
<td>65.0%</td>
</tr>
<tr>
<td>Police</td>
<td>$2,323</td>
<td>$2,355</td>
<td>98.7%</td>
<td>98.2%</td>
</tr>
<tr>
<td>Law Enforcement</td>
<td>$911</td>
<td>$1,043</td>
<td>87.4%</td>
<td>87.8%</td>
</tr>
<tr>
<td>Judges</td>
<td>$306</td>
<td>$276</td>
<td>110.8%</td>
<td>110.9%</td>
</tr>
<tr>
<td>Wildlife</td>
<td>$102</td>
<td>$119</td>
<td>86.3%</td>
<td>86.5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$29,305</strong></td>
<td><strong>$38,891</strong></td>
<td><strong>75.4%</strong></td>
<td><strong>76.0%</strong></td>
</tr>
</tbody>
</table>
PENSIONS FUNDED RATIO DUE TO COLA FREEZE
Title: Pensions; creating the Pension Improvement Act; creating the Pensions Improvement Revolving Fund.

Description: Creates the Pension Improvement Act; creates a new revolving fund for the retirement systems of the State of Oklahoma to be designated the Oklahoma Pension Improvement Revolving Fund.
NON-FISCAL
NEEDS A FUNDING MECHANISM
FUTURE LEGISLATION
ATTACKS ON OK PENSIONS

- Conversion of Systems to 401(k) or defined contribution programs

- Actuaries have studied proposed 401(K) transition plans in more than a dozen states. In each case, they found that it comes with a hefty price tag -- millions or even billions in “transition” costs that are conveniently swept under the rug during political debate.
CONSOLIDATION: BETTING THE FARM

- Consolidation puts over 30 billion in pension assets into the hands of a few political appointees, reducing opportunities for public accountability and oversight.

- Similar efforts in other states have cost taxpayers millions of dollars in transition costs and fees.

- Assuming the very best market conditions, combining the state’s pension boards would produce savings of one quarter of one percent. But a wide array of research shows that even these mere savings might never be realized.
IT’S NOT BROKE, LET’S NOT BREAK IT.

- Bigger is not always better. Multiple pension boards allow for self determination and more flexible investment strategies tailored to the unique needs of each system. Consolidation is a risk Oklahomans simply cannot afford.

- Moving employees into defined contribution systems will only increase the burden on taxpayers and leave retirees with uncertainty and risk. We can’t afford to repeat the mistakes of the past with our teachers, first responders and other public servants.
KPERS administers three (3) statewide, defined benefit plans for public employees, partnering with more than 1,500 state and local government employers

- Kansas Public Employees Retirement System (65% funded ratio)
- Kansas Police and Firemen’s Retirement System
- Kansas Retirement System for Judges
ROOTS OF THE FUNDING SHORTFALL
SIGNIFICANT PLAN DESIGN CHANGES WERE MADE IN 1993

- Common plan design features in most state defined benefit plans
  - Provided unreduced retirement under “Rule of 85”
  - Increased benefit formula multiplier to 1.75% for all service (from 1.4%)
  - Costs of the plan enhancements borne by employers

- Added Statutory cap on employer contribution increases
  - Intended to make enhancements more affordable over short term
  - Statutory rate was expected to converge with the actuarially required rate within a short period
  - However, employer contributions remained below the actuarially required rate from that point forward
• 2003 Legislature gradually raised statutory cap on annual employer contributions from 0.2% to 0.65%

• 2004 Legislature approved $500 million in pension obligations bonds, of which KPERS received $440 million in net proceeds

• 2007 Legislature approved a new, lower-cost plan design (KPERS 2) for all employees hired after 7/1/2009, which included –

  ❖ Later retirement eligibility, eliminated the rule of 85
  ❖ More conservative final average salary definition (5 years vs 3 years)
  ❖ Additional employee contributions (6% vs 4% for Tier 1 at that time)

These changes, coupled with strong investment returns, significantly improved the funding projections
INVESTMENT MARKET DECLINES IN 2008

- The Trust Fund had a -28.5% rate of return on a market value basis
- Substantial negative impact on KPERS’ long-term funded status
- 12% decline in funded ratio to 59%
- $2.7 billion increase in unfunded actuarial liability to $8.3 billion
- School group fell out of actuarial balance, which means the statutory rate would not equal the actuarial rate by the end of the amortization period for the unfunded actuarial liability (2033)
LEGISLATIVE RESPONSE

- 2011 Legislature established a KPERS Study Commission
- Study commission’s hybrid cash balance/DC proposal was not adopted by the Legislature
- 2012 HB2333 legislation was enacted
  - Raised cap on employer contributions
  - KPERS 1 employee contributions increased
  - KPERS2 cost of living feature removed
  - Third tier Cash Balance plan for new members (effective 1/1/2015)
  - Raised statutory cap on employer contribution increases from .60% in FY13 to 1.2% in FY17 and beyond
2012 HB 2333 Provided State contributions from the Expanded Lottery Act Revenue Fund (ELARF) with the purpose of making additional payments toward the State/School Group UAL

- Scheduled to begin in FY2014
- Was expected to continue until the State/School Group is 80% funded
- In practice, contributions from the ELARF have been used to supplement State General Fund expenditures for State-paid employer contributions for School Group

* KPERS has received (FY2014-FY2018) $181.9 million in ELARF proceeds that the legislature has instead used to fund ongoing, annual contributions
2012 HB2333 also required 80% of proceeds from the Sale of Surplus Real property be applied to the UAL

- There have been multiple exceptions made to this provision
- In response to an efficiency study commissioned by the Legislature, 2016 legislation required State agencies to identify all surplus real estate and established a moratorium on the 80% provision
KPERS has received proceeds from the sale of four (4) properties. Proceeds totaled $1.72 million (net of expenses), of which 80% or $1.37 million was credited to reduction of the KPERS unfunded actuarial liability:

- **FY 2014** - $921,070.14
- **FY 2015** - $322,506.20
- **FY 2016** – None
- **FY 2017** - $128,616.86
2015 Legislature approved $1.0 billion in Pension Obligation Bonds (the entire $1.0 billion was credited to the KPERS State/School unfunded actuarial liability)

2016 Legislature delayed $115 million payment to KPERS with a promise it would be replenished (with interest) the following year
2017 Legislative Action:

- Over three years (FY17, FY18, and FY19), the State will pay KPERS $1.63 billion of which $258 million will be layered or paid over 20 years.
- The $1.63 billion is the statutory amount due.
- Assuming the layering payments are made, this will represent 3 years of the State paying at the statutory rate (last done in 2014).
- No payment for the delayed $115 million payment from FY2016.
2017 Legislative Action:

Facing projected budget shortfalls totaling $1.1 billion through June 2019, the 2017 Legislature overrode Governor Brownback’s veto of comprehensive tax reform that rolled back the income tax cuts he championed in 2012.

Since 2012, Kansas experienced multiple credit downgrades by Moody’s citing state budget challenges from depleting cash reserves and deferring pension contributions.

After veto override, Moody’s revised from “negative” to “stable”.
IT’S ALL UP FROM HERE!
Transitioning Investment Authority: A Case Study

Roger Rea
Omaha School Employees’ Retirement System (OSERS)
• OSERS formed in 1909
• Nebraska School Employee’s Retirement System (NSERS) formed in 1945
• All plan benefits are governed by state law
  – Benefits of both plans evolved over time
    • OSERS began as career average salary
    • NSERS began as money-purchase
  – Gradually both plans became final-average-salary plans with same formula benefit, 2%
What about investments?

• For OSERS – overseen by OPS Board of Education
  – First used only government bonds; then added stocks with a “select list” of companies; now use “prudent investor” rule
  – No investments are done “in house” – Use various consultants to recommend asset allocation, manager selection, and monitor performance

• For NSERS – overseen by Nebraska Investment Council (NIC)
  – NIC is an independent state investment agency, and has no administrative role for the retirement plans
What happened?

- Legislature dissolved 12-member OPS Board of Education, and created new 9-member OPS BOE in 2013, and ...
  - OPS got new superintendent, new legal counsel, and 9 new BOE members with limited experience in defined benefit retirement plans
- OSERS Board had 4 plan members; 3 BOE members; 2 business community members; and Superintendent of OPS (10 members total) – all appointed by the OPS Board of Education
- New BOE members had spotty attendance at OSERS meetings and training
- Board of Education had final investment authority and appointed all trustees
- Investment decisions were made at BOE level without adequate knowledge base
- BOE considered appointing entirely new OSERS Board
- Member groups asked for changes in state law regarding the governance of OSERS
What was the result?

• LB 447 introduced in 2015
  – Removed BOE members from OSERS; provided for direct trustee elections; created independent OSERS Board with final authority on all matters
• State senators amended the bill into LB 448, with added features
  – Moved investment authority to NIC
    • No public hearing was held on this provision
    • Move was supported by OPS BOE, opposed by members
    • Move was required to get support of state senators for any changes to OSERS
• Bill stalled on final reading; bill sponsor left legislature and new senator became sponsor
• LB 447 was revived in 2016, with hearing on all provisions that were part of LB 448
  – Moving investments to NIC had a year of study to be sure it could be done without problem – OSERS = $1.2 B; NIC = $23B
    • NIC invests all state money: plan assets for all five retirement plans controlled by state law; College Savings 529 Plan; general state revenues; public endowments; state trusts; etc. (33 different programs)
  – New senator wanted benefit changes, too
    • Rule of 90 at age 60 vs. Rule of 85 at 55; increased “normal retirement age” to 65 vs. 62; loss of part of COLA; loss of service annuity; elimination of provisions allowing “return to work”; minor tweaks in plan administration
    – The “devil is in the details”
• Bill passed with effective date of January 1, 2017 for transition of OSERS investments to NIC
• OSERS became independent, but now only had authority over plan benefit administration, not investments
“The Details”
(where the devil resides)

- Can the OSERS Trust Fund be merged into the investment pools for other retirement plans?
- Who decides the asset allocation?
- What happens to existing money managers?
- How will illiquid investments be handled?
- How and when will transition of investment authority be communicated to members?
- What happens to OSERS staff?
- How will OSERS get money from NIC to pay for benefits?
- What is the “investment philosophy” for NIC?
Some answers

- The OSERS Trust Fund must remain as a separate trust fund for OSERS members, and cannot be comingled with other trust funds.
- NIC will be solely responsible for asset allocation going forward.
- If NIC uses existing money managers, they will be retained – if not they are terminated.
- Investments, such as real estate, for which there may be no ready market will be retained and phased out, vs. having a “fire sale”.
- A joint communication on investment transition will be sent to OSERS members this fall.
- OSERS staff will now be controlled by OSERS.
- A pass-through account from NIC to OPS was created to receive money to pay benefits since all benefit payments are made by the school district (OSERS cannot receive money directly from NIC).
- NIC uses an investment philosophy that looks at risk first, then return (i.e. a risk-averse philosophy).
The **BIG** Question

What is a “risk averse” investment philosophy?

- NIC establishes their risk tolerance first, then looks for allocations that match the risk tolerance
  - OSERS had targeted an investment return first, looked at portfolios that were likely to achieve that return, and then selected a portfolio with a tolerable risk

- NIC targets a 6.5% passive return, with 1% added value from managers (giving a 7.5% assumption)
  - OSERS had targeted an 8% active manager return
After the market decline of 2008, OPS asked OSERS to reduce volatility in the portfolio to minimize need for additional contributions

<table>
<thead>
<tr>
<th>Efficient Allocation Choices</th>
<th>Current</th>
<th>Constrain RE=12%, HY &gt; 22%</th>
<th>Usable</th>
<th>E(r)-50 bps (Less Risky)</th>
<th>E(r)+50 bps (More Risky)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Cap</td>
<td>19.0%</td>
<td>6.5%</td>
<td>7%</td>
<td>5.3%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Small Cap</td>
<td>6.0%</td>
<td>6.3%</td>
<td>6%</td>
<td>5.1%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Intl Equity</td>
<td>13.0%</td>
<td>12.6%</td>
<td>13%</td>
<td>11.1%</td>
<td>14.3%</td>
</tr>
<tr>
<td>Alternatives</td>
<td>10.0%</td>
<td>24.5%</td>
<td>24%</td>
<td>18.9%</td>
<td>30.1%</td>
</tr>
<tr>
<td>Core Bonds</td>
<td>12.0%</td>
<td>10.7%</td>
<td>11%</td>
<td>18.4%</td>
<td>3.7%</td>
</tr>
<tr>
<td>High Yield</td>
<td>30.0%</td>
<td>27.4%</td>
<td>27%</td>
<td>29.2%</td>
<td>24.3%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>10.0%</td>
<td>12.0%</td>
<td>12%</td>
<td>12.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Expected Return</td>
<td>8.8%</td>
<td>9.0%</td>
<td>9.0%</td>
<td>8.5%</td>
<td>9.5%</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>11.1%</td>
<td>11.1%</td>
<td>11.1%</td>
<td>9.7%</td>
<td>12.5%</td>
</tr>
<tr>
<td>Compound Return</td>
<td>8.2%</td>
<td>8.4%</td>
<td>8.4%</td>
<td>8.0%</td>
<td>8.7%</td>
</tr>
</tbody>
</table>

OSERS: Case Study
Changed Allocation to reduce volatility –

note reduced exposure to Large Cap, increased exposure to alternatives

June 2008/December 2009 Comparison
Allocation continued to change:
Asset allocation in Dec. 2016 – Now has Global Equities vs. US; increased real estate exposure; reduced core bonds and high yield
NIC has a different philosophy – OSERS Asset Allocation Jan. 2, 2017: note **increased** exposure to US Equity and Fixed Income; **reduced** exposure to real estate and alternative investments.
Potential Concerns

- How fast will new asset allocation be implemented, and at what transaction cost?
- Will new asset allocation provide long-term returns necessary to pay promised benefits?
- How will increased unfunded actuarial liability resulting from lower expected returns affect employer contribution rate?
- Will investments do well when the investing body ignores needed returns, and focuses on risk?
- Positive note: lower transaction costs can be negotiated for NIC than for OSERS alone
Questions?

The information in this presentation does not necessarily reflect the official positions or views of the organizations referenced herein.