Board of Trustees
Pension Funding Priorities and Guidelines

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EMPLOYEES RETIREMENT SYSTEM OF TEXAS

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EMPLOYEES RETIREMENT SYSTEM OF TEXAS

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POLICY PURPOSE

Adoption of a formal policy defining priorities and guidelines for the funding of pension benefits is a best practice for public retirement systems. The 86th Texas Legislature passed S.B. 2224 (Chapter 453 (S.B. 2224), Acts of the 86th Legislature, Regular Session, 2019) adding Texas Government Code Section 802.2011 requiring public pension plans to adopt a written funding policy. Governing boards and plan sponsors have found that defining a policy helps communicate goals and allows a plan actuary to determine the necessary contribution rates to meet those goals more accurately. By adopting this policy, the Board of Trustees of the Employees Retirement System of Texas (ERS) intends to:

- provide policy guidance to current and future boards;
- enhance communications and provide greater transparency to the Legislature and plan members and retirees regarding Board of Trustees' positions on plan funding strategy;
- ensure that legislators, elected officials and other stakeholders have clear and accurate information about the Trust's funding goals and the needs of the Board in supporting member benefits and sound fiduciary investment decisions in accordance with Texas Government Code Section 815.106; and
- identify a recommended plan for the state of Texas, as the plan sponsor, to achieve a 100% funded ratio while following funding best practices and sound actuarial principles, in accordance with Texas Government Code Section 802.2011.

TRUST BACKGROUND

ERS is a public trust established under the state constitution and statutes to administer four defined benefit retirement plans for a diverse membership that includes judges/justices serving district and appellate courts, district attorneys, members of the Texas Legislature, statewide elected officials and state employees (including Regular Class, and Law Enforcement and Custodial Officers). The retirement trust funds must be administered exclusively in the best interest of fund members and retirees, and cannot be diverted for other purposes.

This document addresses the three pre-funded plans administered by ERS, which include the ERS plan (for Regular Class employees), the Law Enforcement and Custodial Officer Supplemental Retirement Fund (LECOSRF) and the Judicial Retirement System of Texas Plan Two (JRS 2).

Scope of Board authority

This policy, and its potential use and enforceability, is limited by the authority granted to the ERS Board of Trustees. The plan sponsor of the three pre-funded defined benefit plans administered by ERS is the state of Texas. The Texas Legislature determines:

- retirement benefit design of the defined benefit programs administered by ERS;
- state and employer contributions to the pension programs administered by ERS; and
- member (employee) contributions to the pension programs.

The ERS Board of Trustees has authority over the day-to- day administration of benefit programs and the investment of trust assets, including establishing or approving actuarial assumptions, the asset allocation, investment policies and tactical plans for investment asset classes. The Board also has the authority (Texas Government Code Section 814.603) to determine the amount and timing of supplemental annuity payments (sometimes referred to as 13th checks) if the fund is actuarially sound as established by statute (Texas Government Code Sections 811.006 and 840.106) both before and after such payments are made.

Key priority statement: ERS Board objectives

Funding objective

The main objective of ERS' retirement programs is to fully fund the long-term cost of benefits provided by statute, through disciplined and timely accumulation of contributions and prudent investment of assets to deliver earned benefits on a continuing basis.

Funding guidelines

The following priorities and guidelines seek to balance five main objectives:

- **100% Payment of Vested Benefits** – Contributions and current plan assets must be sufficient to pay for all vested benefits expected to be paid to members and their beneficiaries when due. Strong fiduciary management and efficient payment of vested retirement benefits is the Board's fundamental policy, and in the event of any conflict, that policy takes precedence over all other objectives and guidelines reflected in this policy.
- **Contribution Stability and Sound Financing of Benefits** – The Texas Constitution requires that the financing of benefits be based on sound actuarial principles. It is the Board's desire that year-to-year contribution volatility be controlled to the extent reasonably possible in order to achieve and maintain the sound actuarial financing of benefits during the appropriations process.
- **Intergenerational Equity and Responsibility** – The costs of benefits, which are shared between the state (as the employer) and the employee, should be paid for by the generation that receives the benefits, whenever possible, and in a manner consistent with the duty to pay all vested benefits when due and without reduction.
- **Workforce Parity** – Plan design, when possible, should treat the active workforce, other ERS members and annuitants equitably.
- **Quality of Benefit** – System annuitants should receive a benefit that is sufficient to provide a foundation for retirement security.

Summary of key policy terms

Set by the ERS Board of Trustees	
Actuarial Cost Method	Individual Entry Age Normal Cost
Asset Smoothing Method	Closed method: five-year smoothing, direct offsetting of gains/losses
Supplemental Annuity Payments	Case-by-case basis if funds are actuarially sound as established by statute both before and after the payments are paid
Information to Texas Legislature for Items Under Legislative Authority Per Texas Government Code Section 815.106	
Funding Period	Transition from 31-year standard to another standard that is in the best interest of the plan members and retirees and maintains payment of the funding policy rate
Benefit Enhancements (Cost-of-Living Adjustments, Multiplier Increases, Salary Base Changes)	1. Payment for enhancement via lump sum or separate, additional contribution amortized over no more than 10 years 2. Funding period of no more than 25 years before and after payment 3. Funded ratio of at least 90% before and after payment

KEY TERMS

The definitions below describe key terms used throughout the policy.

- **Actuarial Accrued Liability (AAL):** Also called accrued liability. That portion, as determined by a particular actuarial cost method, of the total present value of benefits which is not provided for by future normal costs. It is equal to the actuarial present value of future plan benefits minus the actuarial present value of future normal costs.
- **Actuarially Determined:** Values which have been determined utilizing the principles and standards of actuarial science. An actuarially determined value is derived by application of the appropriate actuarial assumptions to specified values determined by provisions of the law.
- **Actuarially Sound Contribution (ASC) Rate:** The actuarially determined contribution rate needed to pay off any unfunded liabilities within a 31-year period required by Texas Government Code Sections 811.006 and 840.106.
- **Board of Trustees:** The six-member governing body of ERS.
- **Defined Benefit (DB):** An employer-sponsored retirement benefit plan that provides eligible workers, upon attainment of designated age and service thresholds, with a set monthly lifetime benefit based on a formula consisting of the employee's highest average salary, length of state service and a benefit multiplier. The value of a benefit from a defined benefit plan is not affected by the employee's account balance or by the return on the assets that are invested to fund the benefit.
- **Funding Period:** Also referred to as amortization period. Funding period is the length of time, projected into the future, that is required to amortize (pay off or eliminate) the Unfunded Actuarial Accrued Liability.
- **Funding Policy Rate:** The total contribution rate needed to be set by the plan sponsor and paid to a plan to meet the ultimate funding period goal set by the governing body.
- **Funded Ratio:** The ratio of the actuarial value of assets (AVA) to the actuarial accrued liability (AAL). Plans sometimes calculate a market funded ratio, using the market value of assets (MVA), rather than the AVA.
- **Negative Amortization:** Occurs when contributions are insufficient to cover the normal cost and interest on the UAAL. This is similar to an increasing principal amount on a loan due to not paying enough to cover accrued interest.
- **Normal Cost Rate:** The portion of the total present value of benefits and administrative expenses that is allocated to a valuation year by the actuarial cost method. Payment of an unfunded actuarial accrued liability is not part of normal cost. Under the entry age normal cost method, the normal cost is intended to be the level cost needed to fund the benefits of a member from hire until ultimate termination, death, disability or retirement. For pension plan benefits that are provided in part by employee contributions, normal cost refers to the total of employee contributions and employer normal cost unless otherwise specifically stated.
- **Plan Sponsor:** A designated party, typically the employer, which establishes a pension plan for its employees. The state of Texas is the plan sponsor for all pension plans administered by ERS. The Texas Legislature is vested with the authority to set funding levels and benefit design for all ERS-administered pension plans.
- **Plans (ERS, LECOSRF, JRS 2):** Plan membership eligibility is determined by the Texas Legislature.
  1. ERS – DB plan that covers state employees (Regular Class and Law Enforcement and Custodial Officers) and elected officials, including statewide officials, members of the Legislature and district attorneys.
  2. LECOSRF – DB plan providing a supplemental benefit for Law Enforcement and Custodial Officer (LECO) members; if eligible, they receive approximately 80% of their benefit from ERS and 20% from LECOSRF.
  3. JRS 2 – DB plan for judges and justices serving on the district and appellate courts who began service on or after September 1, 1985.
- **Total Present Value of Benefits:** The total actuarial present value of those benefit amounts expected to be paid at various future times under a particular set of actuarial assumptions. It includes liabilities for active members, retired members, beneficiaries receiving benefits, and inactive, non-contributing members either entitled to a refund or future retirement benefit.
- **Unfunded Actuarial Accrued Liability (UAAL):** Commonly referred to as the unfunded liability, this is the excess of the actuarial accrued liability over the actuarial value of assets. This value may be negative, in which case it may be expressed as a negative unfunded actuarial accrued liability, also called the funding surplus.

FUNDING METHODS – SET BY ERS BOARD OF TRUSTEES

Key policy decision: ERS Board sets actuarial cost method

Cost Method Selected: Individual Entry Age Normal Cost
Adopted: August 23, 2017 (as part of the 2017 Pension Experience Study)

For pre-funded defined benefit retirement plans, there is a total present value for all benefits expected to be paid to current plan members. Each plan must select a cost method that allocates the total present value of benefits between past service (actuarially accrued liability) and future service (normal cost).

The actuarial valuation uses the individual entry age normal (IEAN) actuarial cost method. Under this method, the first step is to determine the contribution rate (level as a percentage of pay) required to provide the benefits to each member, or the normal cost rate. The normal cost rate is then split into two pieces: (i) the member's contribution rate, and (ii) the remaining portion of the normal cost rate, which is the employer's normal cost rate. The total normal cost rate is based on the benefits payable to each individual member. Over time, if assumptions remain unchanged, the normal cost rate under the IEAN method is expected to gradually decrease until it reaches the benefit cost of a current new hire.

The unfunded actuarial accrued liability (UAAL) is the liability for future benefits which is in excess of (i) the actuarial value of assets, and (ii) the present value of future normal costs. The employer contribution provided in excess of the employer normal cost is applied to amortize the UAAL.

Key policy decision: ERS Board sets asset smoothing method

Smoothing Method Selected: Closed Method with five-year smoothing and direct offsetting of gains and losses
Adopted: August 23, 2017 (as part of the 2017 Pension Experience Study)

For pre-funded defined benefit retirement plans, pension plans often use asset smoothing. Smoothing takes the annual fluctuation in investment performance and averages it over a period of years. Smoothing reduces volatility in contribution rates by defining a pre-determined period over which both investment gains and losses are recognized. Without smoothing gains and losses, the actuarially determined contributions could vary widely from year to year.

ERS uses a closed method with a five-year smoothing period, meaning that identified smoothing of investment gains and losses are fully recognized within the following five-year period. The method incorporates direct offsetting of gains and losses over a period of time, results in lower year-to-year volatility in contribution rates, and allows immediate offsetting of gains or losses to be recognized.

FUNDING PERIOD – SET BY THE TEXAS LEGISLATURE

A funding period policy is the length of time and the structure selected by the plan sponsor for increasing or decreasing contributions to systematically eliminate any unfunded liability or surplus and achieve a 100% funded ratio.

Sections 811.006 and 840.106, Texas Government Code, in statute since 1985 and 1993, respectively, include a funding period standard of 31 years by prohibiting any benefit enhancement, or other plan design changes, that would result in a period of more than 31 years for paying off any unfunded liabilities. Having a funding period standard in statute is a good practice and serves as the first funding goal level. Standards for funding periods and managing shortfalls or surpluses will continue to evolve.

The Texas Pension Review Board (PRB), a state agency that reviews Texas public retirement systems, as part of its Pension Funding Guidelines (adopted 2017) recommends no more than 30 years to pay off unfunded liabilities, with a preferred target range of 10-25 years.

Several other prominent entities have made recommendations for funding period policies more stringent than Texas' statutory requirements, including:

- Society of Actuaries' Blue Ribbon Panel Report, 2014 and
- Conference of Consulting Actuaries (CCA) Report, 2014.

Key policy statement: funding period goal for unfunded liabilities

(AS INFORMATION TO THE TEXAS LEGISLATURE PER TEXAS GOVERNMENT CODE SECTION 815.106)

This statement lays out a multi-level funding period goal to gradually achieve funding on sound actuarial principles, compliant with Article XVI, Section 67 (a)(1) of the Texas Constitution,

1. Fund Normal Costs

The minimum industry standard is to fund a rate that is at least equal to the normal cost. Contributions equivalent to the normal cost are essential to cover new benefits accrued each year by active employees.

2. Avoid Trust Fund Depletion

With the presence of an unfunded liability, the most urgent goal is to prevent the depletion of retirement trust funds for pre-funded plans because benefits are much more cost-efficient to pay when the benefits are pre-funded and the plan can leverage investment earnings.

3. Meet Current Statutory Standard

The Board goal for funding period is to meet the current statutory standard of 31 years using the current valuation methodology for the Actuarially Sound Contribution (ASC) rate, which is an open 31-year amortization period. Up until the time that each plan reaches a 31-year funding period for unfunded liabilities, the Board directs staff to request funding that will achieve a 31-year funding period, per Texas Government Code Sections 811.006 and 840.106. In order to reach a 100% funded ratio, the plan must receive funding to close the amortization period. A closed amortization period fully pays the unfunded liability by the end of an identified funding period. With an open amortization period, such as the one in place today, the liability gets recalculated each year.

4. Match Funding Period to Additional Standard

Once each plan fund achieves a 31-year funding period, the system will transition to a funding period goal that matches the average years of service at retirement for the ERS and JRS 2 plans. At this point, the plans are expected to no longer be subject to negative amortization. As a reference: In the ERS and JRS 2 plans, average years of service at retirement for a service retiree (excluding disability retirements) were 22 and 15 years as of August 31, 2019 respectively. In order to reach a 100% funded ratio, each plan must receive funding to close the applicable amortization period. A closed amortization period fully pays the unfunded liability by the end of an identified funding period.

CRITERIA FOR BENEFIT ENHANCEMENTS – SET BY THE TEXAS LEGISLATURE AND THE BOARD

The most common types of retirement benefit enhancements include:

- Cost-of-living adjustment (COLA): A permanent adjustment to the base retirement benefit, typically expressed as a percent. A COLA can be a set percent or tied to an index, such as the Consumer Price Index (CPI). The Board has no authority to grant COLAs, which are set by the Legislature.
- Multiplier increase: The percent of salary replaced for each year of service. Currently this rate is 2.3% for ERS and 0.5% for LECOSRF. The Board has no authority to grant multiplier increases, which are set by the Legislature.
- Changes to covered compensation: Currently base salary, longevity, hazardous duty pay and benefit replacement pay are included in annuity calculations. The Board has no authority to grant changes to covered compensation, which is set by the Legislature.
- Changes in salary base: JRS and the Elected Class of ERS receive benefit enhancements when the salary base for the calculation is changed (currently $140,000 per year). The Board has no authority to grant changes to the salary base, which is set by the Legislature.
- Supplemental payment: An ad-hoc post retirement payment. A supplemental payment can be structured as a 13th check, which is a one-time supplemental payment and does not result in a permanent ongoing increase in the annuity. These enhancements are not a regular feature of the pension plans administered by ERS and, therefore, are not built into the cost rates and contribution rates for the plans. The Board has authority to grant supplemental payments and to determine their amount and timing, but it has not historically done so without legislative input. The plan must be actuarially sound both before and after any supplemental payments will be authorized by the Board or paid by the plan.

Key policy statement: benefit enhancement guidelines

(INFORMATION TO THE TEXAS LEGISLATURE PER TEXAS GOVERNMENT CODE SECTION 815.106)

In order to appropriately support the solvency, and protect the financial stability of the plans, all benefit enhancements should be funded at the time an enhancement is approved. The ERS Board of Trustees recommends that the following guidelines be applied when considering benefits enhancements, prior to final approval:

A. Criteria for Granting an Enhancement

1. The plan's funding period should be no more than 25 years, before and after an enhancement.
2. The enhancement should not increase the normal cost of the plan.
3. The plan's funded ratio should be at least 90%, before and after an enhancement.

B. Funding the Benefit Enhancement

1. The State of Texas should make additional contributions to pay off the additional liability created by an enhancement via:
   a. an annual payroll contribution (amortized over no more than 10 years), or
   b. a lump sum equal to the additional amount of liability created.
2. Current employees should not be responsible for paying for retroactive, unfunded annuity enhancements for already-retired members. Employees and retirees must be treated equally.

GUIDELINES FOR FUTURE CONTRIBUTION RATE CHANGES

The State of Texas sets appropriations for a two-year period, and budget commitments beyond amounts required by the Texas Constitution are not guaranteed past a two-year period. To provide an incentive to maintain contribution rates, Section 815.402, Texas Government Code, links the state and member contributions such that any future decreases in the state rate will be matched by an equal decrease in the member rate. In addition, the Texas Constitution, Article XVI, Section 67 requires ERS retirement benefits to be financed based on sound actuarial principles. This constitutional provision also requires a minimum contribution of 6% of current compensation from system members, and a range of 6-10% of aggregate compensation from the state, unless the Governor determines that an emergency exists.

For all pension plans administered by ERS, the Texas Legislature determines the contribution rates. ERS does not have the authority to adjust the contribution rates. The ERS, LECOSRF and JRS 2 plans are currently, and have been historically, funded on a fixed percent of payroll, as required by the constitution. With a fixed-percent-of-payroll funding structure, contribution rates received by the plan are not adjusted each year based on actuarially determined need. This structure is inconsistent with actuarial funding best practices and Article XVI, Section 67(a)(1) of the Texas Constitution mandating that the financing of benefits be based on sound actuarial principles.

In seeking funding during the legislative budget process, the Board directs staff to request funding based on the priorities and guidelines outlined in this document.

MEASURES FOR MONITORING PROGRESS TOWARDS GOALS

The Board will monitor and measure progress toward meeting the goals and guidelines established in this policy by reporting key metrics in each year's actuarial valuation reports. Such metrics will include a calculation of the funding period, funded ratio and unfunded actuarial accrued liability. The metrics will also include a new calculation of the funding policy rate, which is the total contribution rate needed for each plan to meet the funding period goal set by the Board. The information will also be used to develop board meeting documents, legislative presentations, and other internal and external communications.

The Board of Trustees may update this policy, as needed, to reflect significant changes in funding, benefits or methodologies used to monitor funding progress. At least once every four years, following adoption of an experience study, the board will reaffirm or revise this policy to align with plan experience.

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