ERS®
EMPLOYEES RETIREMENT SYSTEM OF TEXAS

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August 29, 2020

Chair Murphy and members of the House Pension, Investments and Financial Services Committee:

Thank you for the opportunity to submit information related to the critical status of the Employees Retirement System of Texas (ERS) pension plans. ERS is entrusted with administering benefits to help you attract and retain a qualified workforce to carry out the important work of the state. These include both health insurance and an employee/employer-funded pension that – when combined with Social Security benefits and personal savings – supports employees in their retirement years. The role of state government is critical – both to the economy of Texas and to the health and safety of its residents. Providing the state workforce with competitive benefits is key to maintaining a strong workforce to achieve the mission of state government.

While the number of state employees has fluctuated through the decades, the current number of active employees in the ERS pension plan is near 141,000. This is approximately the same number of active state employees employed by the state in the early 1990's. As the Legislature has determined to have a lean workforce, it becomes more crucial to ensure that the workforce is efficient, skilled and experienced. When a lean workforce suffers from high turnover, the gaps in service become easily apparent. ERS conducted a member survey in late 2019 and found that 77% of ERS members cited the state's defined benefit retirement plan as a major reason they work for the state[1]. Ensuring the long-term viability of the pension plan is important to both you as the employer and plan sponsor, and to your workforce.

At this time, all three of the pension plans administered by ERS on behalf of the state are in funding distress and on a path to total fund depletion.

Actuarial Valuation Results as of August 31, 2019*			
	ERS	**LECOSRF**	**JRS 2**
Actuarial Accrued Liability	$41.7 B	$1.5 B	$558 M
Actuarial Value of Assets	$28.1 B	$968 M	$468 M
Unfunded Accrued Liability	$13.6 B	$584 M	$90 M
Funded Ratio	67.3%	62.4%	83.8%
Funding Period (Years)	Never	Never	Never
Projected Depletion Date	**2061**	**2041**	**2063**

**Updated for 2020 Experience Study*

[1] https://ers.texas.gov/about-ers/reports-and-studies/reports-and-studies-on-ers-administered-benefit-programs/19097-2019-ret-ben-survey-results.pdf

> ***"The current financial outlook for ERS is very poor. It is important to understand that the currently scheduled contributions are not expected to accumulate sufficient assets in order to pay all of the currently scheduled benefits when due. Based on current expectations and assumptions, ERS is projected to remain solvent until the year 2075. However, based on volatility in the financial markets, there is a strong possibility that ERS will become insolvent in a 30 to 40 year timeframe which is within the current generation of members. Contributions must materially increase in the next legislative session to secure the benefits for current members."***
>
> *Gabriel Roeder Smith & Company, FY 2019 ERS Actuarial Valuation*[2]

In early 2020, the ERS Board of Trustees performed the statutorily required experience study to evaluate both economic and demographic assumptions used for ERS annual valuation. During that experience study, the Board also reviewed the investment asset allocation for the ERS Pension to maximize returns while limiting the Trust's exposure to market downfalls and meeting liquidity needs for monthly annuity payments. Based on recommendations from the system's professional investment consultant and external actuary, in May 2020 the Board adopted new assumptions including reducing the investment rate of return to 7.0%. The Board felt it was important that the assumptions be current in order for ERS to provide the most up-to-date assumptions and funding needs during the upcoming legislative session.

Each year that the funding situation is not addressed depletes the fund sooner. The cost to the state when the fund depletes is at least four times the cost of pre-funding the benefits.

We look forward to working with you and the members of the 87th Legislative Session to return these critically important plans to actuarial soundness.

Please let me know if you need additional information to support your work and research.

Respectfully submitted,
Porter Wilson
Executive Director
Employees Retirement System of Texas

[2] https://ers.texas.gov/About-ERS/Reports-and-Studies/ERS-Actuarial-Valuation-Reports/2019-ERS-Pension-Valuation-Reports-December-2019.pdf

Interim Charge 4: Review and evaluate the actuarial soundness of the Employees Retirement System and TRS pension funds. Examine the cost of and potential strategies for achieving and maintaining the actuarial soundness of the funds. Examine the effect the unfunded liabilities could have on the state's credit. Examine the state's investment policies and practices, including investment objectives, targets, disclosure policies, and transparency.

BACKGROUND

ERS was created effective September 1, 1947 by House Bill 168, 50th Texas Legislature, Regular Session. A constitutional amendment adopted by Texas voters in 1968 established ERS as a constitutional entity (Senate Joint Resolution 39, 60th Legislature, Regular Session). The provisions were consolidated in 1975 into current Article XVI, Section 67. Among the provisions in the Texas Constitution related to the ERS pension plan, there is a requirement that "Financing of benefits must be based on sound actuarial principles."

A six-member Board of Trustees governs the Employees Retirement System of Texas. The three appointed and three member-elected board members oversee investment of the retirement trust funds and the administration of state employee and retiree health benefits. The ERS Board also utilizes an Investment Advisory Committee (IAC) comprised of investment professionals created to consult and advise the ERS Board of Trustees on investments and investment related issues.

ERS manages three pre-funded retirement plans that provide retirement for the state's workforce, including general state agency employees, state law enforcement and custodial officers, and elected state officials, judges, and district attorneys. In addition, ERS administers a closed, pay-as-you-go plan for judges elected prior to 1985 referred to as JRS1. In a pay-as-you-go plan, the sponsor provides money that is equal to the cost of the benefits, rather than pre-funding the benefit cost by providing only a portion of the money and relying on investment returns to fund the majority of the cost.

Roughly 125,000 retirees and beneficiaries currently receive annuity payments from the three pre-funded Trust funds. The pension plans are designed to compensate state employees with steady income in their retirement. State employees, retirees and their beneficiaries live and work in 253 of the 254 Texas counties and help provide support to local economies across the state.

Since its establishment, the ERS retirement plan has been a cost-effective way for the state to provide reasonable retirement benefits to those who serve the State of Texas for their career. The retirement plans administered by ERS are:

Employees Retirement System (ERS) Retirement Trust Fund

- Employees and officers of every department, commission, board, agency, or institution of the State of Texas, except those who are covered by the Teacher Retirement System, JRS 1, or JRS 2
- Members of the elected class, including legislators, statewide elected officials, and district and criminal district attorneys

Law Enforcement and Custodial Officer Supplemental Retirement Fund (LECOSRF)

- Law enforcement officers who are commissioned by the Texas Department of Public Safety, the Texas Alcoholic Beverage Commission, or the Texas Parks and Wildlife Department, or the office of inspector general at the Texas Juvenile Justice Department, and who are recognized as commissioned officers by the Commission on Law Enforcement

- Custodial officers employed by the Texas Department of Criminal Justice (TDCJ), including the Board of Pardons and Paroles, and certified by TDCJ as employees who are required to have contact with state inmates

Judicial Retirement System of Texas Plan 1 (JRS 1) and Plan 2 (JRS 2)

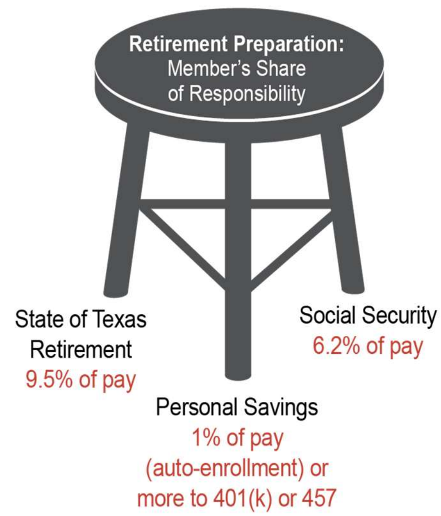
- Judges, justices, and commissioners of the Texas Supreme Court, the Court of Criminal Appeals, the Court of Appeals, and District Courts, and certain commissions to a court

As seen in the chart below, the average retired state employee earns $20,645 each year after serving the state for a little more than 22 years.

Average ERS Plan Retiree	Average ERS Plan Member
69.1 years old currently	43.5 years old currently
58.3 years old at retirement	35.1 years old when hired
22.1 years of service	8.4 years of service
Annuity of $20,645 per year	Salary of $49,220 per year

Member type	**ERS**	**LECOSRF***	**JRS 2**
	State Employees Elected Officials District Attorneys LECOSRF members	Law Enforcement & Custodial Officer Supplement	Judges, justices & certain court commissioners (after 9/1/85)
Contributing Employees	141,865	36,296	573
Non-contributing Employees	125,935	22,207	187
Retirees/Beneficiaries	115,155	13,981	472

ERS manages a retirement trust on behalf of state employees and retirees who are beneficiaries of the defined benefit retirement plan. The money employees and the state contribute each month not only adds directly to the ERS Trust, but also generates interest revenue and investment income for the long-term funding of retirement benefits. Investment earnings make up roughly two-thirds of the ERS Trust's payouts to annuitants, while member and state contributions make up the remaining third.

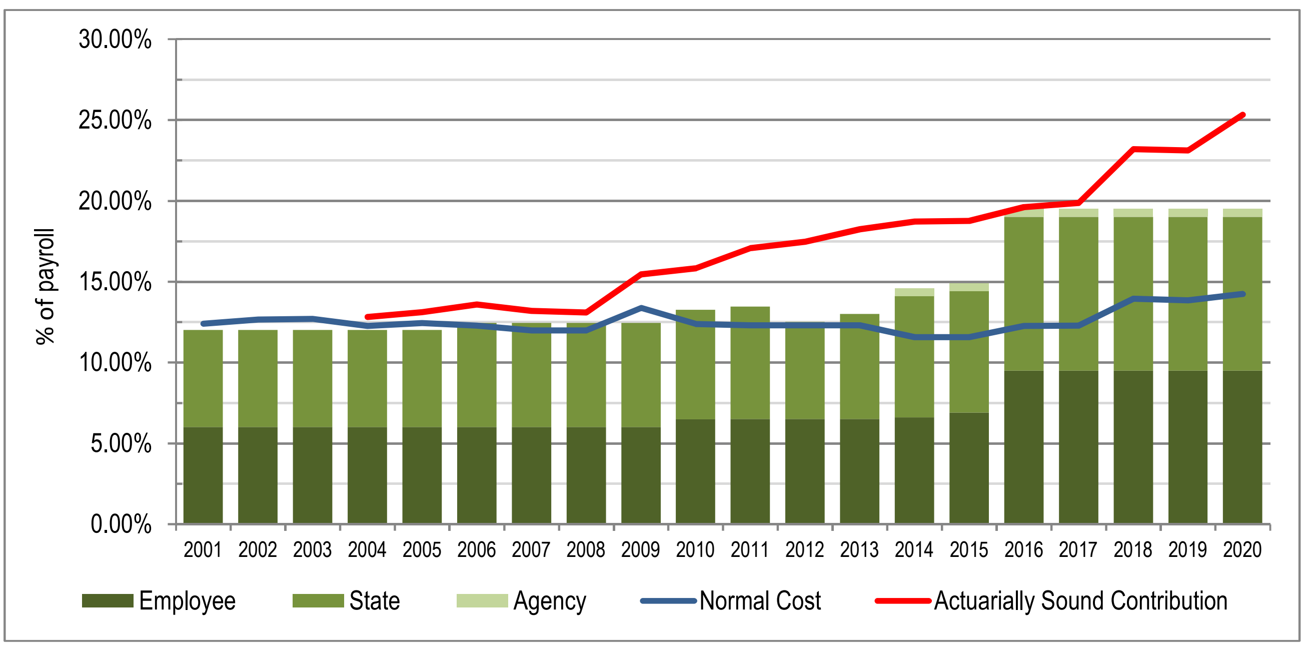


Both the member and the state contribute to the retirement system. State employees contribute 9.5% of their salary to the retirement system. State contributions are currently set at 9.5% of payroll with an additional 0.5% from state agencies. The total combined employee/employer contributions to the plan are 19.5% of payroll. In addition to the state pension contribution, state employees contribute 6.2% of their pay to Social Security and are automatically enrolled (unless declined) in the 401(k)/457 program at 1% of payroll.

Plan Funding

A sound pension fund is achieved when contributions plus investment earnings equal the benefits paid, plus operating expenses. While ERS administers the pension program and manages the investment of trust fund assets, the legislature sets the benefits and contributions levels for the plan. The ERS Board of Trustees has no ability to change benefit levels or alter contribution strategy – that authority lies solely with the Texas Legislature.

While the legislature has done an effective job of keeping the benefits affordable, contribution levels for the pension program have rarely met actuarially sound levels since the mid-1990s. As a result, the pension plan has a significant unfunded liability that has grown, even as the "normal" cost to provide the benefits remains reasonable at just under 15% of payroll[3].



3 As of August 31, 2019 and updated for 2020 Experience Study

To achieve affordable retirement benefit levels, the legislature has adjusted the plan design for new employees twice over the last 10 years. In addition to plan design changes, the legislature has also increased the state and the employee contributions. Investment opportunities were expanded to maximize earning potential. While all these measures have helped, they are still insufficient to fully address the growing unfunded liability. Without further action, the ERS retirement program will continue on the path of fund depletion.

As required by Senate Bill 2224 (Huffman/Murphy), the ERS Board of Trustees adopted the ***ERS Pension Funding Priorities and Guidelines***[4] to help communicate to the legislature a path to returning the ERS plans to actuarial soundness and, further, to achieve 100% funding status[5]. The policy lays out a multi-level funding period goal to achieve funding according to the constitutionally required sound actuarial principles.

1. Fund plan normal cost
2. Avoid trust fund depletion,
3. Meet current statutory standard of a 31-year funding period, and
4. Match funding period to the average years of service at retirement once a 31-year funding period is achieved and closed.

With projected depletion dates for all three plans, the funding period goals are not being met and the state's liability continues to grow and the ultimate cost to the state rises significantly. In the FY 2019 Actuarial Valuation, the external actuaries determined the ERS unfunded liability is growing at a rate of $1 billion each biennium.

Depending on the final performance of the Trust Fund for FY 2020, the request to make the Actuarial Sound Contribution for the ERS plan is estimated to be approximately $340m GR/GRD and $475 AF per year. It is important to note that funding reform does not have to be an "all or nothing" strategy – small, phased-in contribution increases can be an effective plan to reform the contribution strategy for a pension plan.

CHALLENGES

Historic contribution shortage

The ERS pension plan reported the first unfunded liability in 2004. Since that time, the unfunded liability has continued to grow as contributions have not reacted to negative plan and investment experience. The legislature has addressed the growing liability by reducing benefits to state employees hired first after September 1, 2009 and then again for those hired after September 1, 2013. These changes have resulted in the different employee groups in the ERS and LECOS plans.

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[4] https://ers.texas.gov/Shared-Content/Reports-and-Studies/Report_2018_FundingPolicy_2018_FINAL.pdf

[5] The ERS Board of Trustees adopted the initial version in May of 2018 and updated the document in August 2020 to include appropriate references to SB 2224

	Group 1	Group 2	Group 3
		Created by 81st Legislature	Created by 83rd Legislature
	Employees hired before 9/1/2009	Employees hired 9/1/2009 – 8/31/2013	Employees hired on/after 9/1/2013
Minimum retirement Age[1]	60 with 5 years service credit (55 with 10 years LECO)	65 with 10 years service credit or Rule of 80 (55 with 10 years LECO)	
Annuity reduction when retiring before certain age	No reduction	5% per year, 25% cap Age 60 – Regular Class Age 55 – LECO[2]	5% per year, no cap Age 62 – Regular Class Age 57 – LECO[2]
Highest average salary based on:	36 months	48 months	60 months
Multiplier	2.3% - Regular Class 2.8% - LECO[2]	2.3% - Regular Class 2.8% - LECO[2]	2.3% - Regular Class 2.8% - LECO[2]
Unused leave can count toward eligibility?	Yes	No	No
Unused leave can help increase annuity?	Yes	Yes	Yes - if not taken as a lump sum
Membership Count [3]	48,874 (34%)	20,484 (15%)	72,889 (51%)

As of the FY 2019 Actuarial Valuation, 65% of current state employees are members of the reduced benefit groups, Group 2 and Group 3. The normal cost for Groups 2 and 3 is lower than the normal cost for Group 1 which demonstrates that previous benefit reductions have helped minimize the rate of growth of the unfunded liability. Additionally, contributions for both the state and employees increased in FY 2016.

Contribution Strategy

The current ERS pension contribution rates were established during the 84th Legislative Session and prior to that were unchanged for many years. Well-funded and well-designed pension plans have a contribution funding strategy that responds quickly to negative investment performance or actuarial experience.

Many successful plans across the nation, and here in Texas, establish an adequate contribution rate each year that the plan sponsors/employers are required to contribute so that any negative experience or unfunded liabilities are quickly addressed with small changes in the contribution rate. The ERS pension plans are not funded at the statutorily determined sound contribution rate[6]. When funding is not based on the actuarial need of the plan, it can lead to the development of an unfunded liability, which continues to grow until addressed. At that point, it often requires a large contribution increase, which is the case for the state's plan. If contributions were adjusted more frequently, the funding increases would be incremental rather than drastic.

Investments and Negative Cash Flow Pressure

The ERS Board of Trustees is responsible for adopting an investment asset allocation for the ERS Pension Trust Fund. This allocation is reviewed regularly as part of the statutorily requirement to perform an actuarial experience study at least every 4 years[7]. Additionally, the asset allocation is a closely monitored and discussed item at ERS Board of Trustees meetings.

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[6] Texas Government Code §811.006 and §840.106

[7] The ERS Board of Trustees conducted an Experience Study in FY 2020 with final adoption of updated assumptions at the May 2020 meeting. https://ers.texas.gov/About-ERS/Reports-and-Studies/ERS-Actuarial-Valuation-Reports/Pension-Experience-Study-Report-May2020.pdf

When setting the asset allocation, the overarching goals are:

- Manage assets to ensure payment of monthly annuities earned by members and beneficiaries of the retirement plans;
- Seek to maximize investment return while maintaining acceptable levels of risk;
- Reduce risk through diversification;
- Efficiently manage investment program costs; and
- Manage fund assets for the exclusive benefit of plan members

The ERS Board strives to maximize returns while limiting the Trust's exposure to market downfalls and meeting liquidity needs for monthly annuity payments. In FY 2019, the Trust paid out $2.753 billion each year in annuity payments, and received $1.565 billion in contributions[8]. This negative cash flow affects how the Trust can invest assets and puts pressure on the Trust to maintain a higher percentage of liquid assets that can be readily used to pay benefits.

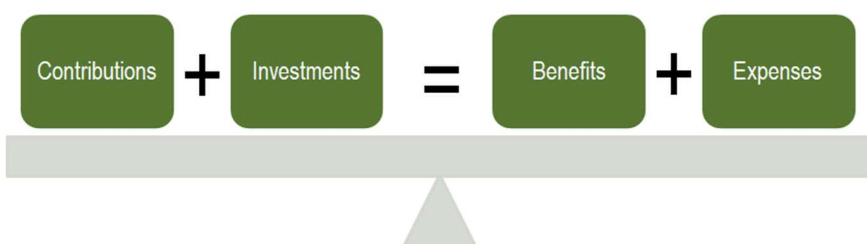
Potential State Credit Rating Impact

Bond rating agencies have taken note of states' pension debt in their rating determination process. As recently stated by Moody's related to Texas' 2020 TRAN issue, "The outlook for the state of Texas is stable. The state's long-term economic fundamentals and its reserve position are strong but reaching structurally balanced budget solutions to the coronavirus-induced revenue downturn will be challenging amid growing demand for education, transportation and pension funding."

While the other positive factors have allowed Texas to maintain its high bond rating, concerns around pension liability is a factor that credit rating agency take note of and, further, expect states to show progress or a plan for addressing unfunded pension liabilities.

SOLUTIONS

A sound pension plan is a balanced pension plan. The equation below shows how a pre-funded pension plan is envisioned to work -- contributions + investment earnings should be equal to (or greater than) the cost of benefits promised + plan administrative expenses.



The path to balancing a plan that is to adjust factors on one side or the other of the equation – increase contributions on the left side of the equation and/or decrease benefits on the right side of the equation. Of all the parts of this equation, contributions and benefits are the two tools that can have a meaningful impact on the rebalancing of the ERS pension plans. Relying on a solution through investments requires dependence on much higher risk investments that may not align with the fiduciary standards of the ERS Board of Trustees and higher returns are not guaranteed. Additionally, the ERS plan administration costs are very low relative to the total cost of the plan and the unfunded liability. Therefore, altering contributions and/or benefits are the factors that have the most significant impact on reforming the struggling ERS pension plans.

[8] https://ers.texas.gov/About-ERS/Reports-and-Studies/Reports-on-Overall-ERS-Operations-and-Financial-Management/2019-CAFR.pdf

Contribution Increase
In preparation for the 87th Legislative Session, ERS will submit an FY 2022-2023 Legislative Appropriations Request for the statutorily determined, Actuarially Sound Contribution (ASC) rate. Depending on the final performance of the Trust Fund for FY 2020, the ASC request for the ERS plan is estimated to be approximately $340m GR/GRD and $475 AF per year. LECOS and JRS2 will have smaller appropriations requests. Again, funding reform does not have to be an "all or nothing" strategy – small, phased-in contribution increases can be an effective plan to reform the contribution strategy for a pension plan.

As other plans across the nation have faced funding challenges for their pension plans, various tools have been used to find alternative sources of revenue to support funding reform. The ERS 2012 report, ***Sustainability of the State of Texas Retirement Program***[9] discussed additional revenue options including general obligation bonds. During this time with historically low interest rates, it may be valuable for the state to research the possibility of utilizing general obligation bonds to address the ERS unfunded pension liabilities. As with all solutions, there are positive and negative implications, statewide debt considerations and basic questions to be answered, however, current economic conditions may warrant further research.

Benefit Changes
Struggling pension plans often look to benefit changes to reduce a plan's unfunded liability. The Texas Legislature took that approach with benefit reductions to then-future employees creating Group 2 in 2009 and Group 3 in 2015. Members in these groups cannot retire until age 60/62 without taking a reduction to their annuity, final average salary provisions have been extended to 48/60 months and neither group permits the member to use unused leave to meet retirement eligibility. With 65% of current, active members in those two groups and 50% in Group 3 alone, the new benefit structure has reduced costs.

Unlike many other plans who can achieve significant savings by reducing or eliminating cost of living adjustments, the state retirement plan was never designed to provide a guaranteed Cost of Living Adjustments (COLA) or automatic bonus check.

The legislature's hard work on past benefit reductions have done the intended purpose of lowering the costs associated with the actual benefit. With the heavy lifting done, there are fewer benefit reduction options that could make a significant actuarial impact on the plan's unfunded liability. The remaining benefit reductions, such as a reduction in the multiplier, would have to be applied to current employees. Reductions of this type could cause a rush to retirement, and negatively impact the state's ability to recruit and retain the workforce it needs.

It is important to note that the current unfunded liability represents benefits that have been earned and cannot be "erased" by changing to a different type of retirement plan structure. In fact, without contributions from members into the existing plan, the current unfunded liability would become larger and more expensive for the state to address. As the funding stands today, a large portion of the current contributions are going toward payment for the unfunded liability – any loss of current contributions for benefits from previously earned service will increase the cost to the state to pay for those required, ongoing costs associated with those earned benefits.

[9] https://ers.texas.gov/About-ERS/Reports-and-Studies/Reports-and-Studies-on-ERS-administered-Benefit-Programs/2012_IBS-Retirement-Report.pdf