Executive Director Update

Actuarial Valuation, Strategic Plan for 2013 Legislative Session & Afterward

December 5, 2012

ATRS received its actuarial valuation on December 3, 2012, from its actuaries. The results from the actuaries are right on point with what the Board and staff have been expecting for several months. The ATRS Board and staff have been actively planning to address issues to maintain the current financial strength of ATRS for years into the future. The actuarial report shows that ATRS has some ground it needs to gain in this fiscal year and subsequent fiscal years, but the amount of ground to gain is not a problem and may be solved by good investment results. If returns are not good enough, the ATRS Board has a list of potential changes that could be implemented to assist the markets in keeping ATRS strong financially.

The actuary's conclusion is that ATRS would need to go up on its employer contribution rate from 14% to 16.85% if all the responsibility was placed on an employer contribution to bring ATRS **immediately** back to a 30-year amortization. ATRS looks at the **2.85%** projected need as **285** basis points. ATRS understands that an increase of 285 basis points to the contribution rate **is not an option**.

The ATRS employer contribution was frozen with a hard cap of 14% by the Arkansas General Assembly in 2006. Since 2005, ATRS has had the 14% employer contribution rate. APERS, the second largest public retirement plan in Arkansas, has not been locked into a frozen contribution rate like ATRS. The APERS' contribution rate will have increased 387 basis points from July 1, 2008 to July 2013. In that same time period, ATRS has had a **zero** basis point increase. ATRS has absorbed the markets losses from the US and worldwide financial crisis of 2008-2009 and the economic downturn thereafter without **any** employer increase and is still a **strong** 71% funded! Without the **quality returns** of ATRS over the years, ATRS would not be in such a relatively strong position.

APERS, unlike ATRS, was able to incrementally increase its contribution rate over the years to address the material impact of the financial crisis and economic downturn that the United States and the world have been fighting since 2008. APERS has done the right thing by also cutting costs and moving its contribution rate as the actuarial results dictate. ATRS, despite having no increase in employer contributions, has continued to remain financially strong by reviewing all benefit structures cutting out excess costs, eliminating benefit provisions that were designed for the benefit of a few at the cost of many, eliminating anti-selection mechanisms, and continuing to streamline ATRS from a benefit cost standpoint.

ATRS has done this while still remaining focused on protecting the **3-Rs** to **R**ecruit, **R**etain and **R**eward career educators. Some may claim that ATRS is more expensive as a retirement system. Part of the cost is that ATRS has great success in recruiting quality educators that stay for a long career and educators live a long time! ATRS mortality tables for ATRS members now have teachers living into their **late 80s**.

ATRS is not requesting an employer contribution increase of 285 basis points. ATRS is requesting the Governor and General Assembly work with ATRS to provide ATRS with a **1%**, or 100 basis points, increase in the employer contribution. This would be the first increase in **7 years**! ATRS is ready to remove this proposed 1% increase as soon as ATRS can do so and still be at a 30 year amortization. ATRS would even accept not increasing the rate at all if ATRS receives a 16% to 17% return in this fiscal year. The ATRS Board is committed to making **every** effort to make up any need through investment returns. ATRS hopes no contribution increases or benefit cuts are needed. If these are needed, the ATRS Board would only do so to the extent necessary to fulfill its fiduciary duty to maintain the financial strength of ATRS.

A 17% return this fiscal year will bring ATRS back to a 30-year amortization on an unsmoothed "real deal" actuarial basis. Several have suggested that the problem with ATRS is that its investment returns have not been good due to "bad decisions". That is just **not** correct. Looking back over long periods of time, ATRS has had excellent returns. I have attached an exhibit that shows the ATRS historic returns going back to 1983. For instance, the average return for ATRS for the last nine years is about 8.1%. For the year ended June 30, 2011, ATRS received a 22% return. ATRS remains committed and forward looking in its investment process to achieve quality returns with as little risk as possible to target the 8% return assumption that the actuary uses in the benefit analysis.

The ATRS Board is reluctant to ask for a contribution increase or any material changes in benefits for current retirees, the benefits rights of active members, or the benefits for future members. At the same time, the ATRS Board is prepared to take the action necessary to ensure the long term stability of ATRS as its ultimate fiduciary responsibility.

Some actuarial highlights from the actuarial report to the ATRS Board are as follows:

1. ATRS only dropped from **72%** funded on June 30, 2011, to **71%** funded on June 30, 2012. Many retirement plans across the country are envious that ATRS remains 71% funded compared to what plans in other states often face. In addition, ATRS is 71% funded on a **real** actuarially "unsmoothed" basis since ATRS merged the actuarial and actual numbers into one result this year since the actuarial value and real value were so close to the same on June 30, 2012. So the actuarial report does **not** include any actuarial smoothing but are the **pure REAL DEAL numbers.**

2. ATRS has an amortization period of over **100 years**. Having over 100 years is not desirable but ATRS has proven that it can overcome such a result. ATRS had over a **125 year** amortization in **2001**. I have attached a chart that shows the ATRS amortization years since 2000. The chart shows how ATRS has always fought back from those high amortizations by cost cutting and quality returns over the following years. In fact, the chart will show that ATRS got down to a 19-year amortization in 2007. Members may question how ATRS went from nineteen years to over 100 years again. That happened due to two things:

    a. ATRS had negative investment returns in 2008 and 2009. In the 2008 fiscal year, ATRS had an investment return of negative 3.7% and the return in 2009 was a negative 18% due to the hard investment punch of **the financial crisis**.

    b. When ATRS had a 19-year amortization in 2007 and 2008, the ATRS Board took action to **help retirees** by compounding the retirees' COLA (Cost of Living Adjustment) that was effective on July 1, 2009. The ATRS Board, unaware of the financial crisis ahead, used quality returns to compound the COLA and still remain well below a 30-year amortization just before the economic crisis caused such devastating downturns in the markets.

    The **good news** from ATRS at this standpoint is that ATRS is 71% funded, and there are **no hidden issues** in ATRS' assumptions. ATRS recently completed a 5-year experience study that updated **all** the member retirement behavior and mortality tables used by ATRS and the ATRS actuaries. Even though the results had bad timing, the results showed that ATRS had **significant** additional liabilities that were added to its books. The experience study that was completed in late 2011 showed that ATRS members are living longer and costing ATRS more than was previously assumed. In addition, ATRS rebased its wage assumptions, inflation rates, and disability retirement usage rates. In essence, there are **no** hidden dangers in the ATRS valuation since everything has recently been updated and ATRS has no smoothing in its current valuation.

ATRS Board response to the funding needs occur without strong returns.

The ATRS Board has used prudent cutting of non-basic benefits in the last four years to keep ATRS stable, along with quality investment returns. The unsmoothed June 30, 2011 actuarial results had a 34 year amortization for ATRS. The fiscal year that ended on June 30, 2012, became the problem. The June 30, 2012 fiscal year ended with a disappointing and essentially flat investment return. The ATRS amortization is now over 100 years. Since ATRS has not had any increase in the employer contribution rate as stated earlier, the ATRS Board is prepared to take necessary action to bring ATRS back to a 30-year amortization in the near term.

The ATRS Board review includes the following options to get back to the desired 30-year amortization rate:

1. <u>Investment Returns Above 8%</u>

   ATRS assumptions include an 8% return on investments. Every 3% return above 8% is equivalent to a 1% increase in the employer contribution rate. An investment return of 11% will generate the equivalent of a 1% employer contribution rate. An 11% return would leave ATRS with 185 basis points to make up. If ATRS has a 14% contribution rate, ATRS would need only 85 basis points since a 14% return would generate excess cash in the future equal to a 2% employer contribution rate increase. If ATRS makes a 17% return, ATRS will not need **any** employer contribution increase or any other material changes in benefits to reach a 30-year amortization. Anything above 17% has the same impact and more in a positive manner.

2. <u>Contribution Increases</u>

   ATRS is asking the Governor and General Assembly for authority for the ATRS Board to implement up to a 1% employer contribution rate if investment returns in the current fiscal year do not return the amounts stated above to bring ATRS back to a 30-year amortization.

3. <u>Changes Affecting Current Retirees, Active Members and Future Members</u>

   In the event investment returns, and thereafter, a 1% employer contribution rate increase are not sufficient to bring ATRS back to a 30-year amortization, the Board has proposed a list of potential benefit changes that could be implemented to bring ATRS back to a 30-year amortization in the near term.

Most of these changes would be changes that the Board would ask the General Assembly to authorize the ATRS Board to implement at some point in the future, but at the same time, changes to benefits would not be implemented **unless** necessary to maintain actuarial funding and appropriate financial strength of ATRS. The plan of the Board is to seek legislative approval that would require the Board to make decisions on what should be adopted when the returns of this fiscal year are clearer, while planning for any implementation necessary on contribution increases or benefit changes. Many of the benefit changes would not occur immediately, even if required, but rather most would be implemented on a contingent basis in future years such as July 1, 2019, in order to prevent members from making a hasty decision to retire that the members would later regret. If the markets return to good returns, then the ATRS Board could repeal the reductions before the actual implementation of the change actually affects benefits.

The ATRS Board's total focus will be on implementing any required changes in benefits to have very little immediate impact. The ATRS Board encourages members to refrain from overreacting to the long list of potential solutions since it is expected many will never be needed.