2010 REGULAR SESSION
ACTUARIAL NOTE SB 594

Senate Bill 594 SLS 10RS-192 **Enrolled** **Author:** **Senator D. A. "Butch" Gautreaux** **Date: June 28, 2010** **LLA Note SB 594.04** **Organizations Affected:** **Louisiana State and Statewide public retirement systems and the Harbor Police Retirement System** **EN SEE ACTUARIAL NOTE APV**	**The Note was prepared by the Actuarial Services Department of the Office of the Legislative Auditor.** David K. Greer **David K. Greer, CPA** **Assistant Legislative Auditor and** **Director of Performance Audit** **and Actuarial Services**

<u>Bill Header:</u> RETIREMENT SYSTEMS: Relative to public retirement systems, provides relative to investments.

<u>Cost Summary:</u>

Actuarial Cost/(Savings) to Retirement Systems and OGB	See Actuarial Analysis Below
Total Five Year Fiscal Cost	
Expenditures	See Actuarial Analysis Below
Revenues	$0

<u>Estimated Actuarial Impact:</u>

The chart below shows the estimated increase/(decrease) in the actuarial value of benefits, if any, attributable to the proposed legislation. Note: it includes the present value cost of fiscal costs associated with benefit changes. It does **<u>not</u>** include present value costs associated with other fiscal concerns.

<u>Actuarial Cost (Savings) to:</u>	**<u>Increase (Decrease) in The Actuarial Present Value</u>**
All Louisiana public retirement systems	See Actuarial Analysis Below
Other Post Retirement Benefits	$0
Total	See Actuarial Analysis Below

<u>Estimated Fiscal Impact:</u>

The chart below shows the estimated fiscal impact of the proposed legislation. This represents the effect on cash flows for government entities including the retirement systems and the Office of Group Benefits, as well as other fiscal concerns.

EXPENDITURES	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**5 Year Total**
State General Fund	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Agy Self Generated	0	0	0	0	0	0
Stat Deds/Other	0	0	0	0	0	0
Federal Funds	0	0	0	0	0	0
Local Funds	0	0	0	0	0	0
Annual Total	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0

REVENUES	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**5 Year Total**
State General Fund	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Agy Self Generated	0	0	0	0	0	0
Stat Deds/Other	0	0	0	0	0	0
Federal Funds	0	0	0	0	0	0
Local Funds	0	0	0	0	0	0
Annual Total	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0

Note: This actuarial note applies only to the provisions of SB 594 amending §263 of Title 11 pertaining to investments of the retirement system. It does ***not*** apply to any of the benefit provisions of SB 594 amending §62, §444, §551, and §553. Actuarial costs associated with modifications to benefit provisions are identified and discussed in the actuarial note for HB 1337.

<u>Bill Information:</u>

Current Law

Under current law, the four state retirement systems, the nine statewide retirement systems and the Harbor Police Retirement System must invest plan assets in accordance with the prudent man rule. This rule is defined as follows:

1. Each fiduciary, acting collectively on behalf of the retirement system, must act with the care, skill, prudence and diligence under prevailing circumstances that a prudent institutional investor in a similar capacity would act.

2. The standard of care is to be applied to investments not in isolation but in the context of the overall investment strategy which includes an asset allocation study and implementation plan that incorporates risk and return objectives reasonably suitable to the trust.

3. The standard of care shall not prohibit investment in small and emerging businesses, small business investment companies, and venture capital firms.

Under current law, LASERS, TRSL, LSERS and the Assessors' Retirement System are subject to the following investment restrictions:

1. No more than 65% of the total portfolio may be invested in equities.

2. At least 10% of the total equity portfolio must be invested in indexed funds.

3. Equity indexed funds may be divested if the S&P composite index declines more than 10% during the 12 month period immediately before the divestment. However, written notice must be given to the House and Senate Committees on Retirement within ten days following the decision to divest.

4. The 10% requirement for equity indexed funds must be restored if and when the S&P composite index increases by more than 10% as measured from the date of the most recent divestment.

Under current law, the remaining state and statewide retirement systems and the Harbor Police Retirement System are subject to the following investment restrictions

1. No more than 55% of the total portfolio may be invested in equities.

2. A system may increase its equity portfolio to 65% of the total fund but if the investment percentage exceeds 55% then at least 10% of the equity portfolio must be invested in equity indexed funds.

Proposed Law

Under SB 594, the four state retirement systems, the nine statewide retirement systems and the Harbor Police Retirement System must invest plan assets in accordance with the prudent man rule. This rule is defined as follows:

1. Each fiduciary, acting collectively on behalf of the retirement system, must act with the care, skill, prudence and diligence under prevailing circumstances that a prudent institutional investor in a similar capacity would act.

2. The standard of care is to be applied to investments not in isolation but in the context of the overall investment strategy which includes an asset allocation study and implementation plan that incorporates risk and return objectives reasonably suitable to the trust. The asset allocation study and implementation plan shall include an examination of market value risk, credit risk, interest rate risk, inflation risk, counterparty risk, and concentration risk.

3. The investment policy shall preserve and enhance principal over the long term and provide adequate liquidity and cash flow for the payment of benefits.

4. Investments shall be diversified to minimize the risk of significant losses unless it is clearly prudent not to do so.

5. No more than 65% of the total portfolio may be invested in equities.

6. At least 10% of the total equity portfolio must be invested in indexed funds.

7. Equity indexed funds may be divested if the S&P composite index declines more than 10% during the 12 month period immediately before the divestment. However, written notice must be given to the House and Senate Committees on Retirement within ten days following the decision to divest.

8. The 10% requirement for equity indexed funds must be restored if and when the S&P composite index increases by more than 10% as measured from the date of the most recent divestment.

SB 594 further mandates that when an investment, action, or asset allocation is considered, the following factors must be given weight:

1. The availability of public pricing to value each investment.

2. The ability to liquidate each investment at a fair market price within a reasonable time frame.

3. The degree of transparency that accompanies each investment.

4. The risk of fluctuations in currency that may accompany an investment.

5. The experience of professionals who will manage each investment and the financial soundness of the business entity employing such professionals.

6. The degree of diversification which exists within each investment and that such investment itself may provide relative to other existing investments in the system's portfolio.

7. Whether leverage is involved.

8. The potential for unrelated business taxable income as defined under Section 512 of the Internal Revenue Code.

9. The jurisdiction of the laws that govern each investment.

10. The net return that is expected relative to the risk that is associated with each investment.

Each retirement system shall submit quarterly reports to the House and Senate committees on retirement beginning with the quarter ending June 30, 2010. Each report must include the investment rate of return, administrative expenses, board-approved target asset allocation, and current actual asset allocation. Investment returns must be provided for each asset class and the total fund for the quarter reported, fiscal year to date, one year, three year, five year and ten year periods.

Implications of the Proposed Changes

SB 594 establishes a single set of guidelines for the investment of retirement system assets applicable to all public retirement Systems in Louisiana. The new set of guidelines generally provides clearly direction regarding the selection of individual investments.

Modifications to HB 1337

SB 594 modifies HB 1337 as it applies to retirement benefits for judges employed on or after January 1, 2011. These changes are identified and discussed in the actuarial note for HB 1337.

Cost Analysis

Analysis of Actuarial Costs

Retirement Systems

All public retirement systems in Louisiana will have to review their investment strategies to ensure compliance with SB 594 and restructure their portfolios if not in compliance. The effect of the new requirements will vary from system to system.

The most fundamental actuarial equation is:

Benefits = Contributions + Investment Earnings

According to this formula, benefits must be paid from contributions and/or investment earnings. And, the greater the investment earnings of a plan, the lower contributions will be.

If SB 594 is intended to reduce investment risk and contribution volatility, then long term investment returns on restructured portfolios may be smaller than returns expected on current portfolios. Asset and contribution stability will be achieved, but investments returns may be compromised.

An analysis showing the effect of the risk reduction contemplated by SB 594 on expected investment returns could not be completed in the time frame allowed for the preparation of this actuarial note. Nevertheless, plan liabilities and contribution requirements are very sensitive to investment earnings. If a new investment strategy reduces investment expectations by 25 basis points (one quarter of one percent), then the actuary for the plan should decrease his valuation interest assumption accordingly. A 0.25% decrease in the valuation interest assumption will have the following effects on cost elements for LASERS and TRSL.

Increase in Cost Elements Attributable to 0.25% Decrease in Valuation Interest

	LASERS	TRSL
Employer Normal Cost	$ 17.5 million	$ 21.5 million
Unfunded Accrued Liability	399.5 million	743.8 million
Employer Normal Cost	$ 17.5 million	$ 21.5 million
Amortization Cost	35.5 million	64.0 million
Total Employer Contribution	$ 53.0 million	$ 85.5 million
Employer Normal Cost Percentage	0.6%	0.5%
Employer Amortization Cost Percentage	1.3%	1.3%
Total Employer Contribution Percentage	1.9%	1.8%

It is not intended to suggest that SB 594 will lead to a reduction in the valuation interest assumption. SB 594 may or may not lead to a reduction of expected earnings and therefore may or may not lead to a reduction in valuation interest rates. The purpose of this chart is merely to illustrate how sensitive cost factors are to expected investment returns.

Other Post Retirement Benefits

SB 596 will have no effect on actuarial costs associated with other post retirement benefits.

Analysis of Fiscal Costs

According to the retirement systems, there will be no additional administrative costs associated with SB 594.

Dual Referral

Senate	**House**
☐ 13.5.1 ≥ $500,000 Annual Fiscal Cost	☐ 6.8(F) ≥ $500,000 Annual Fiscal Cost
☐ 13.5.2 ≥ $500,000 Annual Tax or Fee Change	☐ 6.8(G) ≥ $500,000 Tax or Fee Increase or a Net Fee Decrease