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Nebraska Retirement Systems Committee
February 22, 2016

[CONFIRMATION]

The Committee on Nebraska Retirement Systems met at 9:00 a.m. on Monday, February 22, 2016, in Room 1525 of the State Capitol, Lincoln, Nebraska, for the purpose of conducting a public hearing on two Gubernatorial appointments and a review on the Omaha Public Schools Employee Retirement System Actuarial Report. Senators present: Mark Kolterman, Chairperson; Al Davis, Vice Chairperson; Brett Lindstrom; and Heath Mello. Senators absent: Mike Groene and Rick Kolowski.

SENATOR KOLTERMAN: Welcome to everybody to the Nebraska Retirement Systems Committee hearing. My name is Mark Kolterman. We have with us...I'm from Seward. We have Brett Lindstrom from Omaha. We have Senator Al Davis from Hyannis. And we have Senator Heath Mello from Omaha. Kate Allen is our committee legal counsel and Katie Quintero is with us as our clerk. And then we have Robert...Robert, where are you from?

ROBERT LARSEN: I'm from Papillion.

SENATOR KOLTERMAN: From Papillion. We're here today to have a couple of appointment hearings, and then we're going to evaluate the Omaha School Employees Retirement System Actuarial Valuation. So we'll start out this morning with Gubernatorial appointment, J Russell Derr. Come forward, please.

J RUSSELL DERR: Good morning, Senators. How are you this morning? [CONFIRMATION]

SENATOR KOLTERMAN: Good morning. Welcome. [CONFIRMATION]

J RUSSELL DERR: Good. My name is J Derr. I'm a district court judge for the state of Nebraska. I was appointed and confirmed by the Legislature in May to fulfill or fill the remaining term of Judge Rehmeier on the Nebraska Public Employees Pension System Board. And I was reappointed by the Governor. And subject to your advise and consent, I would be pleased to continue serving on this board. I...the seven or so months that I've served, I've enjoyed it. The people are terrific over there. And so, if you have any questions, I'd be more than pleased to address them. [CONFIRMATION]

SENATOR KOLTERMAN: Are there any questions? Seeing none, thank you. And thank you for your service. [CONFIRMATION]

J RUSSELL DERR: All right, thank you for your time. Thank you. [CONFIRMATION]

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SENATOR KOLTERMAN: Are there...here to...testimony in support? Opposed? Neutral? We'll close the hearing on Judge Derr. The next one is Keith Olson. [CONFIRMATION]

KEITH OLSON: Hi. Good morning. [CONFIRMATION]

SENATOR KOLTERMAN: Good morning. [CONFIRMATION]

KEITH OLSON: I've been appointed by the Governor to be a member on the Nebraska Investment Council. I thought it would be a good opportunity for me just to give you a little bit about my background. I'm sure there must be something in the packet, but just to fill in some areas. Was born in Sioux City, Iowa. My parents had six kids in six years and I'm a twin in the middle. At the age of...when I was three years old, my family moved to Des Moines, Iowa. My father was in the...was with the Nebraska...was with the telephone company, Northwestern Bell Telephone Company. And at the age of ten moved to Grand Island, Nebraska, and spent a couple of years there. And then to Omaha where I graduated from Millard High School. At that point, at that time there was just one of them. Went on to the University of Nebraska at Kearney; undergraduate in business and economics. Came back to Omaha. Worked at the Youth of Omaha Fund Management Company for four years and received my MBA at the University of Nebraska at Omaha in their night program; at the same time accomplishing and achieving and passing the CFA program. From there it has been a long and winding road to New York City to work for Brown Brothers Harriman, which Brown Brothers asked me to go to Tokyo for them and set up their investment office, which I did. I spent four years in Tokyo and accomplished that; built that team and came back to New York City with Brown Brothers Harriman. Then I found a very, very interesting job working for the Caisse De Depot Et Placement Du Quebec in Montreal; ended up in Quebec bringing in-house and activating their Asia/Pacific equities. And so I did that for six, seven, eight...seven years or so and then went to Hong Kong to work for an investment management company there. That was in 2003, and then recently came back to Omaha to be with my parents; to spend more time with my parents and my family and to get involved in some of my interests here in Omaha. That's it in a nutshell. [CONFIRMATION]

SENATOR KOLTERMAN: Thank you very much. Are there any questions?
[CONFIRMATION]

SENATOR DAVIS: I guess I just have to say you had quite a career; very, very interesting work.
[CONFIRMATION]

KEITH OLSON: Thank you. It's been very interesting and fascinating. And when I was in Kearney even, I was very...always very interested in investments, even before, in high school. At University of Nebraska-Kearney, I really got this passion for thinking globally. And what was

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happening at that time in 1979, the Shah was kicked out of Iran. And with that, all of a sudden, you know, share prices are being determined by factors outside of the United States. If I'm going to be competitive as an investment professional, I really need to understand the global community and how that can impact share prices as well. So I really developed this passion to think globally. And that has taken me on this long and winding road. [CONFIRMATION]

SENATOR DAVIS: Do you feel your expertise in, I guess, overseas stocks to be beneficial for the Investment Council? [CONFIRMATION]

KEITH OLSON: I strongly believe that to be the case. The Nebraska Investment Council has done a very, very good job of globalizing the asset-allocation process over a number of years. I think that has been beneficial in terms of both establishing reasonable returns, but certainly managing risk very well also. [CONFIRMATION]

SENATOR DAVIS: Any observation on the Japanese deflationary phase? [CONFIRMATION]

KEITH OLSON: I could talk about that for the next three days, I think. But briefly, Japan has been in this condition since 1990. When Sumita, the previous Minister of Finance, his term was over, that...in his term as the Governor of the Bank of Japan, so he was Governor of the Bank of Japan. He's the one that flooded Japan with all kinds of money. Monetary policy just gone crazy. Real estate prices like this, the stock market like this. The palace in Tokyo, emperor's palace was worth more than California. Their market...the Japanese market was larger than the U.S. market...equity market. That ended when a new Governor of the Bank of Japan came in; raised rates, collapsed the equity market, collapsed the real estate market, the banking system went bust and Japan has never recovered from that. It will be extremely difficult for Japan to recover as a nation with population declining and the aging population advancing as it is. You know, 70 percent of the wealth is with people that are 70 years old or older, with interest rates that are actually starting to go negative. It's a tough time. But as you point out, in a deflationary era, if you have...if you're earning zero interest rates, you're still okay. That's why the equity market, to some degree, at least domestically has...the equity market has gone as...essentially there's no...the culture of the equity market has died in terms of...in Japan. Now globally it can fit in certain ways if certain securities in certain parts of that nation that are...that do phenomenal. But as a nation, to answer your question, that's my view. I don't see a change. [CONFIRMATION]

SENATOR DAVIS: Thank you. [CONFIRMATION]

SENATOR KOLTERMAN: Any additional questions? Thank you for your willingness to serve. And we look forward to hearing more from you and your colleague over there.
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KEITH OLSON: Okay. Wonderful. Thank you very much. [CONFIRMATION]

SENATOR KOLTERMAN: Anybody here to testify in support? Against? Neutral? So we'll close the hearing. Thank you both for coming this morning. Okay, now we'll move into the actuarial valuation report. I meant to tell everybody to spell your name. We have theirs on the record already. So will you spell your name, please? [CONFIRMATION]

PATRICE BECKHAM: (Exhibit 1) All right. Patrice Beckham, P-a-t-r-i-c-e, Beckham, B-e-c-k-h-a-m with Cavanaugh Macdonald, 3906 Raynor Parkway, Bellevue, Nebraska. Good morning, Senators. My pleasure to be back with you again; give you your quarterly dose of actuarial science. And this morning I'd like to spend my time with you reviewing the results of the September 1, 2015, actuarial valuation for the Omaha School Employees Retirement System. That's their measurement date, a little bit different than the statewide system. So I believe you all have copies of the presentation that kind of highlights the information, so we'll walk through that. On page 3, just a little reminder what the actuarial valuation process is all about. We're really measuring assets and liabilities, comparing them and then developing a way to fund the difference. The liabilities, of course, are the promises to pay benefits in the future. A lot of unknown information there as to what they will actually be, and so we use actuarial assumptions to help with that process to estimate the future benefit payments and the probability of those payments and then we discount them back and put them in terms of today's dollars. We use the funding policy developed by the board to calculate what we call an actuarial contribution rate. But as you know, their funding is very similar to the state school system in that we're attempting to fund it with a fixed contribution rate. So we calculate an actuarial contribution rate and kind of use that as a litmus test to see how close the fixed statutory contribution rates are and, again, to look to see if there's any trends or anything to be concerned about. So on slide 4, you might remember, we've talked before, that an actuarial valuation is a point-in-time measurement. We often try to do projections to show you how things change over time, but this is a calculation of a single point in time and we need to remember that. Again, that projection involves looking at future benefit payments and calculating liabilities, comparing it to assets, and then, again, developing kind of an actuarial contribution. Every time we do evaluation, we capture what's happened to date and then we look forward to estimate what's going to happen in the future. We're sort of always recalibrating every year in the valuation. The assumptions are a critical part of any valuation for a defined benefit plan, including Omaha School Employees. If we used a different set of assumptions, we would get different numbers; no doubt about it. So the assumptions are set, trying to be the best estimate. Remember, this process is sort of allocating the cost of the benefit structure across time periods to both the members, because they share in the contributions, and the employers/taxpayers. So we're not trying to be overly conservative nor overly aggressive and kind of shoot for the middle part, kind of the "reasonable" is the term that actuarial (inaudible) use. All right, so we'll talk about membership, assets, liabilities, contribution rates, in that order. On page 5, a little bit of information on the active membership.

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You may remember that there is a new tier for Omaha schools, just like there is for the state school system, that began July 1, 2013. For Omaha schools though, it's a single employer, so we actually get data to identify whether members are certificated or noncertificated. And so you can see the breakdown: the top half there, certificated members, that number is going down because that tier is closed. All the new folks are going into Tier 2. So we have a little over 20 percent of our current active population in Tier 2. Now there's far less liability with that group. A. They're short service, right? And all your retiree liability sort of attributable to Tier 1 as well. And then, again, for the classified members, you can see that change in tier from '14-15 will continue to see that shift, probably, another 10 to 15 years before the majority are in Tier 2. On the next page, slide 6, again, looking at all the groups, you can see the active count--really pretty stable. They're just good in a defined benefit plan. You like that to be stable or even increasing, is healthy for this type of a plan. And then the people who are vested, they have a right to a benefit, but they haven't met the eligibility to start that. Those are your terminated vested; up about 5 percent, and then the retirees and beneficiaries are actually receiving benefit payments. So overall, 12,728 members. There are a number of folks who are nonvested and entitled to a refund, but their liability has been included in the valuation, but I didn't include them here.

SENATOR DAVIS: Pat.

PATRICE BECKHAM: Yes, sir.

SENATOR DAVIS: Terminated vested, can you tell me what that means again, please?

PATRICE BECKHAM: Yes. It means they worked long enough to be vested in the benefit that they earned for their years of service, but they're not eligible to retire yet.

SENATOR DAVIS: So they've moved on to some other job somewhere else?

PATRICE BECKHAM: Correct...correct.

SENATOR DAVIS: Thank you.

PATRICE BECKHAM: But they have a right to come back and draw that benefit once they're at least 55. All right, so page 7. Again, I know you've heard this before, but in the valuation process we use something called the actuarial value of assets which is a smooth value. And Omaha schools uses a different smoothing method, another commonly used one in public sector. But this one we actually take last year's actuarial value and say, well, in a perfect world, all the actuarial assumptions are met. If that happened, where would our assets be? Recognizing the money that

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comes in and goes out. And then we compare that to actual market and we recognize 25 percent of the difference. So it's a little bit of a weighted average: 75 percent of the expected; 25 percent of the market...actual market. And that's the method that is used for the OSERS valuation. If you look at the next page on page 8, a little bit of information on the rates of return on market versus actuarial. So the blue line is the rate of return on market value volatility; there it speaks for itself. And then the red line with the squares is the rate of return on the actuarial, the smooth value. But you could see over this particular time period, even with the smooth value, the majority of the time it's been below the assumed rate of return. Okay, and when that happens, we're sort of losing ground. Our liabilities are going to continue to grow at 8 percent, but the assets aren't tracking with that; we're losing ground on the long-term funded basis. And the specific rate of return for fiscal year '15 for Omaha schools was just...was a minus 4.1 (percent). On the smooth value, there was enough, sort of, deferred gains that we hadn't recognized before that we still had a plus 5.3 (percent), so that helped a little bit. On slide 9, when we did the 2014 valuation, the market value was actually \$17 million higher than the actuarial value. So when that happens, we have what we call deferred gains. The actual market is higher. Well, as you might guess, with a minus 4 percent return, that sort of flip-flopped. And so now, the actuarial value is higher than market; \$102 million higher, and so we have unrecognized or deferred investment loss at that point. Page 10 will show you the actual numbers in millions. Again, if you look at the lump top line, the September 1, '14, valuation, you can see the market value, again was higher than actuarial value: \$75 million in contributions and \$107 million in benefit payments going out. Then the 9/1/15 values market was about \$1.2 billion, in actuarial \$1.3 billion. So there's that deferred \$102 million, the difference there. And the same returns we've already talked about there. Page 11, kind of giving you a little bit longer historical view of the asset values. Again, the blue bars are actual market, and the red are actuarial. And it just helps us look over time and kind of make sure that there isn't a bias in our smoothing method that we are seeing them kind of converge back. Again, but over this period for the most part, the returns have not averaged the 8 percent, so it's probably not surprising that the bulk of the time the market value in this period lies below the actuarial value. Page 12, we've talked before about the funded status, the funded ratio. And remember that is using the smooth value, the actuarial value. And I included a breakdown on the actuarial accrued liability on this slide so that 63 percent of the total actuarial accrued liability is attributable to inactives. That includes people receiving benefits and then those terminated vested folks that we talked about earlier. Active accrued liability about \$670 million. So the total is just under \$1.8 billion. Again, that actuarial smooth value is \$1.3 billion. So the unfunded actuarial for liabilities is \$486 million. And the ratio of which we took actuarial assets and divided it by liability which is, perhaps, a little bit better way to look at when numbers are so big, 73 percent funded, down slightly from last year with 74.1 (percent). On a market-value basis, the funded ratio last year was 75 percent and this year would be 67 percent. So the...we're seeing that minus 4 percent return when you look at peer market. On page 13, the valuation gives us a chance to kind of look in-depth at the experience and see how that changed the unfunded actuarial accrued liability from one valuation date to the next. So an aggregate, the

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unfunded liability in the 2014 valuation was \$446 million; we ended up in the '15 valuation at \$486 (million). The question is--how did we get there? And that's what this reconciliation is showing you. I'm not going to walk through every number, but just a couple of things. The expected change in the unfunded liability, and I know we've talked about this with the statewide systems, when the plan to pay it off has an increasing payment stream in terms of dollars, it's level as a percent of pay, but we expect payroll to increase. That means in the early part of the payoff period, you're not bringing in enough dollars to cover the interest on the unfunded. So by design, it's expected to go up. That's the \$9 million. Last year, the statutory contribution rate was greater than the actuarial rate. So extra money kind of came in. And any time extra money comes in, it goes to pay down the unfunded liability. So that's the \$5 million. And so conceptually, those numbers aren't big, but I'd like you to understand those conceptually. Then the big one is investment experience, because we had, remember, about a 5 percent return rather than the 8, so that was \$34 million. And then if you kind of lump all the liability experience together, it's about \$6 million loss. Okay, the biggest there from retirement experience. It tends to be either more people retiring or younger folks...kind of Rule of 85, people retire...more of them retiring than we expect. Any questions on that slide? Okay. The next page, page 14, again, looking over a longer term and the funded ratio, and again, this is using the actuarial or the smooth value, you can see it's held very steady for about the last seven or eight years, just above, you know, 70 percent...the low 70s; the high back in about 2006 about nearly 90 percent funded. So we measure the liabilities compared to the assets and we need a systematic way to figure out how much money should go in each year. And that's what the actuarial contribution rate is. So it has those two pieces. The active people that are working, there's a cost that should be put in for them now; because the theory is, we're going to fund the benefit while people are working. So only active folks have a normal cost. That's sort of the ongoing cost, it's driven by the benefit structure. As you can imagine, the higher the benefit, the higher the normal cost, that's an easy one. But it's also driven by the assumptions...you assume people are going to live longer--there's a higher cost to that; retire earlier--there's a higher cost to that. And then the actual people that are in the plan have an impact on that as well. The second piece of it is that payment, because our assets aren't really...at least where they would theoretically be in a perfect actuarial world, we have to bring in enough money to make up that unfunded liability in the future. It's not an immediate need, but we need a plan to pay that off. And for OSERS, they're paying off over a closed 30 year period. That means every year that number comes down one; that's what the "closed" means. But it began September 1, 2013, so it's two years into it. So for the '15 valuation, we were spreading that payment, for the unfunded liability, over 28 years. On the next page, page 16, you can see the actual numbers here. For the actuarial contribution rate, the normal cost is just under 12 percent. Okay. And again, over time we would expect that to trend down as more folks move into Tier 2, which is a lower cost benefit structure. And then the amortization of the unfunded liability is 8.8 (percent) this year. So the total is 20.76 (percent). And the members are contributing 9.78 (percent). The district statutory contribution is 101 percent of the employer rate, so 9.88 (percent). The state is contributing 2 (percent). And so we actually this year have a

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little bit extra coming in, which we're calling a margin, because there's not a really good word for that, but it's down a little bit. Last year you can see that margin was 1.43 (percent) and this year it is 0.9 (percent). So it's down a little over half a percent. But that would say for this year there's no additional contribution required, that the regular statutory rates are sufficient. Now it's worth noting, again, because all of our work with funding is done with smooth value, it's just prudent to remember, kind of, where things are in a market-value basis. So if we use market and ran these numbers, it actually almost flips. You can see the little footnote, there's actually a contribution shortfall of 0.94 percent if we use pure market. So what that tells you is if there isn't favorable experience coming in the next few years to kind of offset the unrecognized losses, we're headed in that direction over a period of time. Right. I'll just wrap it up. So we did have actuarial losses this year. You saw the largest component of that was from investment experience. That increased the unfunded actuarial accrued liability. We now have deferred losses rather than deferred gains to the tune of about \$102 million. And even though there's no additional contribution this year, we need to be aware that we do have the deferred investment loss. We saw the impact if we calculated the contribution rate using pure market. But if we look over time, we have a couple of things moving in opposite directions. So we've got the new people coming in to Tier 2, which is a lower cost plan. So those costs are going to come down. But we've got deferred losses which may force it up. And so it's very hard, actuarially, without a model to really tell you where things are going. So there's a lot of caveats there. If we were able to sort of ignore all of that and assume we are at 8 percent on the actuarial value, the system's unfunded liability would be paid off in 24 years. But again, there are a lot of moving parts, in particular, on these retirement systems, so wouldn't come with a guarantee for sure. I'd be happy to answer any questions you might have.

SENATOR KOLTERMAN: Thank you, Pat.

PATRICE BECKHAM: You're welcome.

SENATOR KOLTERMAN: Any questions? Good report.

PATRICE BECKHAM: Thank you.

SENATOR KOLTERMAN: Appreciate it.

PATRICE BECKHAM: My pleasure.

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SENATOR KOLTERMAN: Seeing no questions, this hearing is going to end real quick. We appreciate you coming today, thank you very much. This hearing is over with. Thank you, everyone.