MINUTES OF STATE FISCAL ACCOUNTABILITY AUTHORITY MEETING

April 19, 2016 – 9:30 A. M.

The State Fiscal Accountability Authority (Authority) met at 9:30 a.m. on Tuesday, April 19, 2016, in Room 252 in the Edgar A. Brown Building, with the following members in attendance:

Governor Nikki R. Haley, Chair;
Mr. Curtis M. Loftis, Jr., State Treasurer;
Mr. Richard Eckstrom, Comptroller General;
Senator Hugh K. Leatherman, Sr., Chairman, Senate Finance Committee; and
Representative W. Brian White, Chairman, Ways and Means Committee.

Also attending were State Fiscal Accountability Authority Director Grant Gillespie; General Counsel Keith McCook; Governor's Deputy Chief of Staff Austin Smith; Treasurer's Chief of Staff Clarissa Adams; Comptroller General's Chief of Staff Eddie Gunn; Senate Finance Committee Budget Director Mike Shealy; Senate Finance Committee Budget Director Mike Shealy; Ways and Means Chief of Staff Beverly Smith; Authority Secretary Delbert H. Singleton, Jr., and other State Fiscal Accountability Authority staff.

Adoption of Agenda for State Fiscal Accountability Authority

Upon a motion by Senator Leatherman, seconded by Rep. White, the Authority adopted the State Fiscal Accountability Authority agenda as proposed.

Public Employee Benefit Authority and SC Retirement System Investment Commission: Update (Regular Session Item #1)

Upon a motion by Senator Leatherman, seconded by Rep. White, the Authority received as information an update from the Public Employee Benefit Authority (PEBA) and the SC Retirement System Investment Commission (RSIC). No action was required by the Authority.

Appearing before the Authority were Peggy Boykin—Executive Director of PEBA; Joe Newton and Danny White—Gabriel Roeder Smith & Company (Actuaries); and Michael Hitchcock—CEO of RSIC. Copies of the presentations made on behalf of PEBA and RSIC are attached and incorporated herein by reference. Senator Kevin Bryant also attended the meeting.

Governor Haley noted that it is important that there is transparency regarding what is happening at RSIC. She said it is important for everyone to hear what the Authority members already know.

PEBA

Ms. Boykin reminded the Authority that the statutes require an annual valuation. She said the valuations are required to determine the needed contributions to sustain the Retirement Systems at a minimum requirement of a 30-year amortization period. She said the 30-year amortization period is set in statute. She noted that one of the primary reasons for the valuation is to determine the required contribution rate for both employees and employers. She stated the June 30, 2015, valuation was presented to the PEBA Board in November and December 2015 through their committee process and then up to their Board. She said that as part of the valuation they were informed that the required contribution increases would have to be increased by at least three basis points to maintain that thirty-year period. She stated if the investment losses from last year were not recovered it would ultimately be roughly a half percent. She noted that while the PEBA Board adopted the three basis point increase they did so with the caveat that they may need to revise that recommendation after receiving the experience study. Ms. Boykin further noted that the experience study is the five-year study required by statute that evaluates the assumptions to determine whether any changes need to be made on those assumptions. She said that some of the assumptions go to the General Assembly and stated that the rate of return is not an assumption that PEBA or the SFAA has control over and should be addressed by the General Assembly. She stated that PEBA is waiting to see what the General Assembly does with the rate of return. She said there are two pieces of legislation pending concerning the rate of return. She noted that Senate bill S.675 states that if the General Assembly does not take action on the rate of return the decision then goes to PEBA and ultimately to the SFAA. She said House bill H.5007 says if the General Assembly does not address the rate of return the matter goes directly to the SFAA to set the rate of return. She said that as soon as legislation passes or some action is taken on the rate of return PEBA will be in a position to send the rest of the assumptions to the Authority for approval no later than the June 7 meeting and that will be timely for the actuaries to use the revised assumptions when they prepare the June 30, 2016, valuation. She said that valuation will come before the close of this calendar year.

Gabriel Roeder Smith & Company (Actuaries)

Mr. White made the presentation on behalf of the actuaries. He advised the Authority that the presentation would cover the 2015 actuarial valuation results and the 2016 experience study. Mr. White noted that the state code allows for flexibility in developing the contribution rates and that the PEBA Board has the discretion to increase employer and employee contribution rates up to 50 basis points. He said they have recommended that the increase go up three basis points to maintain the 30-year period and consider going up additional amounts to further improve the funding plan.

Mr. Loftis asked what the fascination is for 30 years when the law reads it can be a maximum of 30 years. Mr. White said that is the maximum and the three basis points put it at the maximum. Mr. White said being at the maximum is at the discretion of the PEBA Board. Mr. Loftis asked if the PEBA Board has the discretion to lower the amortization period to 29 years if it wanted to. Mr. White said this is about the contribution rate and not the amortization period. He said the PEBA Board has the discretion to increase contribution rates which has the effect of decreasing the funding period. Mr. Loftis reiterated that the statute does not say that the period has to be 30 years.

Mr. Eckstrom said that part of the confusion is that Ms. Boykin stated that the statute sets the amortization period at 30 years. He said what Ms. Boykin meant was that the statute sets the maximum as not to exceed 30 years. He noted that in 2011 the amortization period was at 25 years.

Senator Leatherman commented that the amortization period has been below 30 years and can get there. He said the way to get below 30 years is to increase the contributions. Mr. Loftis said that decision needs to be made and noted that it would take 21 years to get to a period below where it needed to be. Senator Leatherman reiterated that the employer and employee contribution rates have to be increased in order to do that. Mr. Eckstrom commented that another answer is in investment returns and that there are any number of solutions to be pursued. He noted that there is a financial crisis within the Retirement System with the deficit growing at about a billion dollars a year. He said the interest on the accumulated deficit is not liquidating.

Senator Leatherman said the General Assembly is addressing the issue by allowing for a half percent increase in employer and employee contribution rates. He said they are committed to making the retirement system sound. Mr. Loftis commented that the Retirement System will always be sound because no matter how much money is lost the State still has to pay.

Governor Haley asked Mr. Loftis what his changes would be. Mr. Loftis said the PEBA changes are needed now. He said the investment portfolio should be changed. He said this matter is not about pension, but about government funding and how current funding for pensions is taken and spent on other things. He said borrowing from the pension plan is a relief valve for funding other items.

Mr. Eckstrom stated that too much grace has been given when it comes to making hard choices on funding. He said it is a matter of priority where the funds will be spent and on what. He said he cannot think of a greater priority right now than dealing with the accelerating unfunded liability. He said the approach should be to invest with two objectives in mind. He said one is to have an alpha portfolio and a liability beta portfolio. He stated the beta portfolio would be a portfolio that is invested to take care of ongoing needs of the system. Mr. Eckstrom said the objective should be to provide stability and security for the Retirement System. He said the alpha portfolio should be invested differently to attack the unfunded liability to liquidate it. He said as the unfunded liability gets liquidated the alpha portfolio should get shifted back to the beta portfolio which should be invested to provide stability and security to fund the plan going forward. He said the focus has been too global without enough detail when it comes to making an investment decision because there has been no recognition of the objectives of taking care of the exploding unfunded liability and taking care of the assets of the plan to provide stable retirement benefits. He stated that to do so will require some form of liability index where the liability is customized.

Mr. Loftis further commented that PEBA was on notice in November 2015 when the RSIC voted that the numbers were not going to be met and that the 30-year projections were lowered. He noted that the General Assembly may or may not pass the legislation. He said action needs to be taken.

With regard to the JSRS, Mr. Eckstrom commented that it has an obscenely high benefit structure. Mr. White said that the JSRS provides a benefit of approximately 90% of final average pay after 32 to 33 years of service. He says the retirees in this system receive an automatic increase if the position the person retires from receives an increase in retirement benefits. Senator Leatherman commented that looking at the benefits structure might explain why there is a shortage of people applying to be judges. Mr. Eckstrom said that given the benefit the judges receive they should be willing to contribute more.

Mr. White also reviewed with the Authority the 2016 Experience Study. He noted that state statute requires that the study be done every five years. He said the last experience study was approved by the Budget and Control Board in November 2011. He said the result of the 2016 experience study was provided to the PEBA Board in February 2016 for recommendation. He noted that assumptions are developed and taken before the PEBA Board for it to accept, reject, or modify the recommendations. He said the outcome of what PEBA does will come to the SFAA for approval. He also noted that the investment return assumption is baked into state statute and that the General Assembly has control over the investment return assumption. He said that is one reason the PEBA Board is waiting to see what the General Assembly does before they bring recommendations before the SFAA. Mr. Loftis commented that the legislation may or may not get passed, but that PEBA has to go ahead and act based on the information it has. He said he would like to see the recommendations as soon as possible.

Governor Haley asked what was the status of Senate bill S. 675. Mr. Shealy said the bill is in the House. Rep. White said that it is in Ways and Means and that H.5007 is before full committee. He said they are working on something that will pass both bodies.

Senator Leatherman further asked if the actuaries have calculated the contribution needed to get the Retirement System whole in 30 years and asked if an increase would be needed. Mr. Newton said that with the new assumptions an increase would be needed do to that. Mr. White said that in 2015 the minimum contribution rate by statute was going to be 11.09%. He said if the assumptions are adopted as recommended, the recommended contribution rate for the employer would be 12.28% reflecting a 1.19% increase in the rate. He noted that the employee contribution rate will also increase by the same 1.19%.

In further discussion, Mr. White and Mr. Newton discussed the summary of recommendations as outlined in their presentation. They also answered questions about the projected contribution rates and recommended assumptions.

Rep. White asked what does the guaranteed COLA cost. Mr. White said the benefit is already reflected. He said if there were no COLA the unfunded liability would decrease by $3 billion. Mr. White said that assumes there is not another increase that will be built in.

RSIC

Mr. Hitchcock advised the Authority that the RSIC understands that it has underperformed and they understand why they have underperformed. He said RSIC understands the market challenges and how they can do better over time through asset allocation and organizational changes.

He said considering that they are in a compressed return environment their relative performance has been a little more positive even though returns are negative. He said moving out in time RSIC falls in comparison to their peers. Mr. Eckstrom asked how different would the results be if the universe of plans was the major pension plan of each state instead of the 32 plans that are over $5 billion. Mr. Hitchcock said in terms of relative performance the results would be about the same with the State being in the bottom quartile.

Mr. Eckstrom asked why the plan is underperforming against the benchmark. Mr. Hitchcock said that is a reflection, in part, of a three month lag in some of the private market investments and implementation. Mr. Jeff Burg, with RSIC, said over a longer period of time the plan is under risked versus other plans and over a shorter period of time the underperformance is caused by the underperformance of the plan's credit strategies. He said that in recent times companies (in the portfolio) that have been deemed to be troubled have traded down significantly in price.

Mr. Loftis commented that the State's plan has the lowest benchmark of any plan in the country. He said there is always a truing up of the plan about mid-year and the State's plan is always at the bottom ten percent.

With regard to the RSIC's graphic on historic trailing returns, Mr. Eckstrom asked what was meant by "overlay". Mr. Burg said an overlay program is designed to be the cheapest form of implementation.

Mr. Hitchcock noted that the historical conviction RSIC held was that RSIC employs a conservative asset allocation that emphasizes protection in catastrophic down market scenarios. However, he said when they went through their fiduciary audit, Funston's thoughts were that their "current asset allocation is a complex and costly form of insurance against catastrophic drawdowns." He said he believes that RSIC's original thought was that by giving up some participation in positive markets they were paying insurance premiums. He said last year he began looking into that strategy because RSIC's performance did not look like it was going to be great for the fiscal year. He said they ran the asset allocation through various regression scenarios to see the type of downside protection they had. Mr. Hitchcock stated that he was not pleased with the results because the conviction did not bear out to scrutiny. He stated that is when they went on a conviction exercise and tried to get back to basics.

Mr. Hitchcock further stated that part of the underperformance is that RSIC has had a 15.6% underweight in its portfolio that has been exposed to the U.S. domestic market in the last five years as compared to its peers. He said that is a return of 16.8% and that has been the driving force between them and their peers. He noted that other detractors were an overweight to short duration and that commodities have not done well.

Governor Haley said that she wanted to know where RSIC was heading from this point. Mr. Hitchcock said they are in the process of challenging their convictions. He said in November 2015 they reduced their cash allocation from 5% to 2% and took that 3% and put it into public equity. He said they eliminated their static target to private markets. He stated their investment decision is no longer "top-down", but is now based upon the merits of individual investment. He also said they adopted new asset allocation and can earn a better return over time.

Mr. Hitchcock further stated that the new asset allocation will be phased in over three years. He also noted that near-term market performance will likely significantly impair the ability of any pension fund to achieve its assumed rate of return.

Senator Leatherman asked if anyone knew what needed to be done if the assumption rate was reduced to 7%. Mr. White said recommended assumptions at 7% would mean a contribution rate of 12.9% for employers and would be 10% for employees.

Governor Haley said that she wants to hear from Senator Leatherman and Rep. White what the Authority should do from this point. Senator Leatherman and Rep. White said they would like to hear from the Authority members as well concerning their thoughts of what should be done. Rep. White noted there has to be a plan that is financially feasible for the State. He commented that the State did not get into this ditch overnight and it is not going to get out of it overnight.

Information relating to this matter has been retained in these files and is identified as Exhibit 1.

Adjournment

The meeting adjourned at 11:10 a.m.

[Secretary's Note: In compliance with Code Section 30-4-80, public notice of and the agenda for this meeting were posted on bulletin boards in the office of the Governor's Press Secretary and in the Press Room, near the Authority Secretary's office in the Wade Hampton Building, and in the lobbies of the Wade Hampton Building and the Edgar A. Brown Building at 3:30 p.m. on Friday, April 15, 2016.]