Analysis

State Treasury

Target-Date Fund Report

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Request: Acknowledge receipt of a report on target-date fund change.

Recommendation: Acknowledge receipt of the report.

Analysis: The Interim Joint Committee on Ways and Means (January 2018) instructed the State Treasury to report to the Legislature in 2018 with an explanation of why the Individual Account Program (IAP) target-date fund change that was initiated by the Oregon Investment Council (OIC) was necessary, what other options were evaluated, and the implications of the change (*see Item #46: Interim Joint Committee on Ways and Means - Individual Account Program Target-Date Fund Change from January 2018*).

While OIC's target-date fund decision may be financially prudent for IAP members, and the PERS system overall, the implications of such a financially material decision are not fully understood by the Legislature and, likely, IAP members themselves. Although "long-running" discussions of the target-date change occurred within the Executive Branch, the proposal merited little, if any, discussion during the Legislative session in 2017.

Individual Account Program

The IAP includes over 250,000 member accounts for Tier One, Tier Two, and Oregon Public Service Retirement Plan (OPSRP) benefit plans. The IAP, an account-based plan nearly identical to a defined contribution plan, is funded with member contributions, which is 6% of a member's salary. The member contribution can be paid by the employee or assumed and paid by the employer; generally, the contribution is made on a pre-tax basis. Since inception on January 1, 2004, the IAP has been invested no differently than other assets in the Oregon Public Employees Retirement Fund (OPERF). The IAP has no guaranteed rate of return and earns a "market" rate of return. IAP returns have been variable at a high of 18.47% (2009) to a low of -26.75% (2008). The IAP ten-year return is 6.62% (including 2008), the five-year return is 9.22%, the three-year return is 7.81%, and the one-year return is 14.45%. The IAP currently has a balance of approximately $9 billion (or 12%) of the total $76.7 billion PERS portfolio. Of note is that the IAP has no unfunded liability and is not included in actuarial valuations because IAP assets are not available to pay a pension benefit.

Background

On September 20, 2017, an administrative decision by OIC moved the IAP to a target-date fund solution beginning January 2, 2018. The target-date solution is an age-based approach that moves a member's IAP assets into an increasingly conservative investment portfolio as the member ages to help protect against market fluctuations. The OIC change initiated a glidepath that included moving approximately $2 billion in IAP assets into outside investors to facilitate the target-date fund structure at initial implementation. OIC's target-date solution is a mandatory change for IAP members. The target-date solution provides for no member choice to make individual investment decisions. As a result, some member account earnings are projected to be less than 5% per annum, well below the current assumed earnings rate of 7.2% and recent calendar year 2017 actual earnings crediting of 14.45%.

OIC's justification for this policy change is summarized by the State Treasury Investment Division's Chief Investment Officer:

> ...the most important objective in the transformation of the IAP is actually to protect the DB [defined pension benefit] side of the OPERF from an inopportune and potentially very disruptive capital call.

OIC's legal justification for the change is based on ORS 238A.050(3) that gives OIC the authority to invest assets of the IAP differently from the OPSRP pension program. Of note is that investment of Tier 1 and Tier 2 pension assets fall under a different statute. The legislative intent behind ORS 238A.050(3) was presumably the prudent investment of IAP assets rather than to use IAP assets to "protect" the illiquid investment positions held by the pension benefit portion of the OPSRP portfolio. IAP was never designed to be a counter-investment, or offsetting investment, to pension benefit investments.

Implications of the OIC Decision to IAP Members

The following are the general implications to IAP members and state agencies. There could be further implications to future PERS reform options as well.

The underlying concern with OIC's decision is that it is essentially a de facto defined contribution benefit change for PERS members. The IAP was instituted as part of PERS reform legislation passed during the 2003 legislative session and was originally estimated to pay approximately 15-20% of a retiree's final average salary (for a 30-year career) based upon the assumed earnings rate at the time the program was created (8%). Under the OIC target-date fund, this replacement ratio may be reduced to 10% of final average salary.

The PERS Board, at its September 29th meeting, expressed several levels of concern with the OIC decision. Some thought the OIC target-date fund was too "coarse" a tool that did not allow for IAP member choice when it came to making individual investment decisions. Also, some had difficulty understanding the logic of why de-risking such a relatively small percentage of a member's retirement was necessary, or prudent, given that around 85% of a member's retirement, including any benefit derived from Social Security, is pension-based. The IAP de-risking was viewed by some as too conservative of an approach.

Given the generally lengthening longevity of retirees, a more aggressive investment of IAP accounts could be viewed as prudent. The counterargument is that if IAP accounts remain invested long-term in the same manner as the rest of the PERS portfolio, a market downturn at an inopportune time could jeopardize a portion of a PERS member's retirement.

Implications of the OIC Decision to PERS

The OIC decision has implications to PERS, the agency. The 2017-19 legislatively adopted budget for PERS included no funding for the target-date solution. PERS has requested, and Interim Joint Committee on Ways and Means has recommended, supplemental funding to backfill expenditures that the agency has had to make to conform the agency's information technology infrastructure to the target-date solution to be ready to implement the solution by the January 2018 effective date set by OIC. This request will likely be the first installment of such costs. The agency may also need funding for customer service, education, and outreach related to the change. Investment advice is outside of the purview of PERS.

The OIC decision also significantly impacts the PERS IAP information technology project that has been underway since 2013 and is designed to bring the administration of the program fully in-house. The business case for the project was to allow PERS members to have a single platform for the reporting of their pension and IAP retirement benefits. The move to target-date funds will necessitate that annual earnings crediting be specific to individual member accounts rather than an overall crediting. In addition, IAP costs for a third-party administrator will increase; however, that cost increase has yet-to-be determined. The OIC target-date decision has eliminated all savings on which the project was based and resulted in a major reconfiguration of the project at a yet-to-be-determined impact to the project's scope, schedule, and budget (*see interim Joint Committee on Ways and Means Item 45 - PERS Individual Account Program request from January 2018*). There may also be broader implications to the OPERF and the assumed earnings rate; however, the OST report made no mention of how the assumed rate might be impacted.

Implications of the OIC Decision to Treasury

The 2017-19 legislatively adopted budget included no funding for the target-date solution in the State Treasury budget. The investment of IAP accounts in target-date funds will be through three vehicles: (1) OPERF; (2) passive index investing through contracts with external private investment firms as opposed to in-house Treasury's Investment Division staff; and (3) the state's Oregon Short-term Fund, for which the State Treasury will charge a fee. OIC has had to hire a glidepath management firm to structure the transition to a target-date fund and hire an index fund manager. These costs, as well as those of State Treasury, are net of investment earnings.

Legislation in 2018

HB 4159 was introduced in response to OIC's administrative action and is under consideration by the Legislature. This measure provides for IAP member choice in investment selection or election beginning on January 1, 2019. If this measure becomes law, the OIC's target-date solution would still remain a mandatory change for IAP members, and without member choice to make individual investment decisions, for a one-year period. Then, beginning January 1, 2019, the OIC decision would be statutorily overturned and IAP members would be allowed a choice in investment selection. The measure provides an exemption from standard procurement law in order to meet this timeline. The State Treasury has reported to the Legislature that it is "...researching with legal counsel the potential ramifications of IAP choice to the pension fund...that review will examine options to introduce participant choice within the new framework while simultaneously safeguarding OPERF's legal status and access to private market investment opportunities," according to OST's report to the Legislature.

The fiscal impact of this measure is indeterminate; however, additional funding of expenses, once determined, will need to occur this biennium and will be material. A preliminary estimate for PERS alone is between $5-$10 million. Revenue transfers from earnings on the invested funds would fund the request. Future biennia costs are also anticipated. The change from no member choice to member choice, if enacted by the legislature, will be a cost factor.

Recommendation

The Legislative Fiscal Office recommends acknowledging receipt of the report.