MINUTES OF THE RHODE ISLAND PENSION ADVISORY WORKING GROUP

DATE: 02 November 2023

Rhode Island General Treasurer James A. Diossa commenced this meeting at 4:00 p.m. and offered introductory remarks concerning the pension system and legislative charge.

Treasurer Diossa then introduced each member of the Rhode Island Pension Advisory Working Group and named Working Group Members George Nee and Michael DiBiase as Co-Chairs.

Pension Advisory Working Group members present:

George Nee, Co-Chair, Pension Advisory Working Group
Eric Atwater
Patrick Crowley
Thomas Huestis
John P. Maguire
Laura Quinby
Edinaldo Tebaldi

Two absent members of the Pension Advisory Working Group were represented at this meeting by designees. Ernie Almonte was represented by Jennifer Slattery. Jonathan Womer was represented by Brian Daniels.

Pension Advisory Group members absent:

Michael DiBiase

Rhode Island Office of the General Treasurer staff present:

Eileen Cheng
Robert Craven
Gonzalo Cuervo
Frank Karpinski
Justin Maistrow

A quorum being present, Chair Nee called Joseph Newton, Gabriel Roeder, Smith ("GRS"), to provide an actuarial assessment of the Rhode Island pension fund as it existed in 2011, as it currently exists, and the status of the system had the General Assembly never passed the Rhode Island Retirement Security Act of 2011 ("RIRSA").

Mr. Newtons testimony was segmented in to four parts. The first addressed the impetus for RIRSA. The second explained the nature and intent of the 2011 reform. The third was intended to provide a current overview of the Employees' Retirement System of Rhode Island ("ERSRI") and Municipal Employees' Retirement System ("MERS"). The fourth and final assessed where the state pension system might be but-for the 2011 reform.

What prompted the 2011 reforms?

When RIRSA was introduced, Mr. Newton testified that the state pension system was 48.4% funded. At the time, the state maintained a Defined Benefit ("DB") plan. The set of benefits in place at the time both increased the unfunded actuarial accrued liability ("UAAL") – thereby decreasing the funded ratio – and caused employer and employee contribution rates to spike around 2010. This occurred the same time as external economic events, which caused further financial strain on the system.

The 2010 valuation determined the employer contribution rate (the state payments to maintain the current benefits package, expressed as a percent of employee payroll) to be 35.25% for teachers, and 36.34% for state employees (compared with 22.32% for teachers and 22.80% in the prior year). Contemporary projections expected the contribution rates would continue to rise to approximately 44.73% of an employee's annual salary by 2015 and remain there through 2030 – the end of the existing amortization period.

The RIRSA was intended to create an affordable system that would be sustainable in the long term, while balancing the equities of benefit cuts to active and retired members of ERSRI and MERS. Mr. Newton testified that sustainability can be improved from three areas, based on the actuarial funding equation:

$$\text{Contributions} + \text{Investment Earnings} = \text{Benefits}$$

Since investment earnings were not expected to rise above projected return rates in a material way, systemic sustainability would have to come from an increase in the employer and employee contribution rate, a cut to benefits, or a combination thereof. Mr. Newton testified that the ability to utilize re-amortization was limited since benefit payouts would have needed to occur well before the system received the corresponding contributions.

The nature and intent of the 2011 reforms.

Given that the reform package was expected to cut benefits to the DB plan and freeze cost of living adjustments ("COLAs") for retired members of the pension system, Mr. Newton testified that there was research into different sources of replacement income. Third-party data indicated that 70 to 78% of a retired employee's working income was sufficient in retirement. Contemporary projections suggested the replacement income from the state pension would be 80% of income for a Schedule A employee after 35 years of service, and 68% of income for a Schedule B employe after 35 years of service following reform. Mr. Newton estimated that social security would account for an additional 33%, inclusive of the impacts associated with government pension offset and windfall elimination provisions. With the Defined Contribution ("DC") plan for certain active members and all future members created by RIRSA, Mr. Newton estimated the total plan value to be approximately 111% to 103% of income for a lifetime employee (assuming 7.5% and 6.5% returns on the DC plan, respectively), as compared with 108% of income under the pre-reform benefit structure.

For teachers not in social security, the reform increased employer and employee contribution rates by 2% to compensate for the absence of social security income. With the increased contribution

rate, the total value of a lifetime employee was estimated to be approximately 104% to 91% of income employee (assuming 7.5% and 6.5% returns on the DC plan, respectively).

Mr. Newton stated that RIRSA has occasioned $1.0559 billion dollars in cost savings to the state in the years since passage. In 2013 alone, the state portion of pension contributions decreased from $243 million to $169.7 million. Mr. Newton testified that the RIRSA reforms helped to reign in and stabilize annual costs in the intervening years as well. Projections indicated that costs would have grown markedly between 2013 and 2029 absent reform. Due to the benefits change, annual employer and employee contribution rates also decreased by about 15 to 18% of payroll, depending on the year. These cost savings have positively impacted the funded ratio. Over the intervening years, the funded ration has increased 12.2 percent, from 48.4% to 60.6%.

In response to a question from Mr. Atwater, Mr. Newton confirmed that retired members of the pension system took the largest benefit cut but stated that vested and non-vested employees were impacted in prior reforms, which reduced their overall benefits package.

Present state of the Pension System.

Mr. Newton testified that the pension fund is currently projected to reach 80% funded by 2030, and 82.3% funded by 2031. Fund growth has slightly outpaced 2011 projections, which forecast the fund would reach 80% by 2031. The UAAL has also steadily declined during the intervening years and is expected to continue to fall so long as the state continues to make the annual required contributions ("ARC") and assuming there are no additional changes to the pension system. Actual and projected contributions have been relatively consistent over the past decade. For the upcoming fiscal year, the state contribution is projected to be $374 million. The state share is expected to peak in 2035 at $450 million before falling again thereafter.

While growth has been relatively slow since 2011, contemporary forecasts showed that the fund would stay between 50 and 60% funded for about ten years. This growth rate is attributable to negative cash flow associated with a large retiree population and large benefit payouts to that class of retirees. Over the past ten years, if the fund was returning about 7% – the assumed rate of return – only about 1% stayed in the fund, with the remainder being used to pay benefits. As negative cash flow continues to improve, the funded ratio will accelerate at a much faster pace.

In response to a question from Mr. Atwater, Mr. Newton clarified that negative cash flow is common in public pension plans. Public pension plans are intended to generate earnings off investments and pay benefits with those earnings. In any given year, it is thus expected that more is paid out in the form of benefits than is received in the form of employer and employee contributions (thereby creating negative cash flow), but that payout is supplemented by investment earnings to keep the funded status stable. At the time of pension reform, the funded ratio dropped too low, so there were not enough assets to generate sufficient investment returns to pay benefits. The fund is now much closer to a normal range, where 3 to 4% of returns stay in the system.

Mr. Atwater inquired as to the impact re-amortization has on negative cash flow. Mr. Newton indicated that further re-amortization would have increased negative cash flow in the first few years following reform.

Mr. Atwater inquired as to whether 7% is a commonly used by public pension plans for the assumed rate of return. Mr. Newton responded in the affirmative. 7% is the current mode and median expectation of state pension plans across the country. At the time the State Investment Commission ("SIC") voted to decrease the expected return rate from 7.5% to 7% in 2011, the median expectation was 7.5%. In this regard the state was more conservative than its peers.

State of the Pension System Absent Reform.

Mr. Newton next analyzed the hypothetical state of the pension fund absent reform with all else remaining equal. Over the past 11 years, the state has contributed $3.4 billion to the pension system. Had RIRSA never been enacted, however, contributions as a percent of payroll would have been about 20% higher on average, with about 50% of payroll as the state (employer) contribution rate. Consequently, projections indicate the state share of contributions would have been $6.3 billion – $2.9 billion dollars higher than the state's actual contribution. Assuming the state met its contribution obligations, the funded ratio would be approximately 61%. But if the state underfunded the system in any way, in any given year, the funded ratio would have been negatively impacted and continued to decrease in each successive year.

Mr. Crowley inquired as to whether this projected cost savings considered the decline in the number of state employees since 2011. Mr. Newton indicated that this projection is based on a stable population but explained that the head count does not have a material impact on current projections.

Other Observations.

Mr. Newton testified that the salary increases for long service state employee and teacher has not kept pace with pre-reform increases. The five-year average salary increase for state employees and teachers was 3.5 and 4.2%, respectively, for long service employees between 2001 and 2005. From 2016 to 2020, the five-year average salary increase for state employees and teachers was 2.8 to 2.7%, respectively. As a result, contribution rates were lower, since the state contribution rate is expressed as a percent of employee payroll. If employees receive less in pay, the state contribution rate is lower. Turnover has also been higher, on average, over the past decade. However, Mr. Newton cautioned that employee salaries and turnover rates are impacted by a myriad of factors, and neither can be directly attributed to RIRSA alone.

Summary.

In summation, Mr. Newton testified that the RIRSA did accomplish what was intended. The current structure was designed to share risk, not lower the expected overall benefit provided. The newest structure provides a benefit in line with industry best practices for a career employee. Moreover, there have been no further benefit cuts since reform and actual contributions have tracked very close to projected contribution rates. The COLA freeze continues to account for the largest portion of cost savings (approximately 85 to 90%) but they are expected to return by 2030.

Mr. Newton concluded in urging the Working Group to be mindful of the actuarial finding equation. A change to one variable must be offset by a change in another to balance the equation and ensure adequate funding. Therefore, contributions must increase if benefits rise.

Mr. Maguire inquired as to whether the majority of the cost savings occasioned by pension reform came from retirees. Mr. Newton testified that the COLA freeze accounts for the most significant cost savings, and that the COLA freeze impacts retirees and those eligible to retire.

Mr. Maguire inquired as to the impact of the reform on teachers in the state who do not have social security and are in the hybrid plan. Mr. Newton testified that ERSRI members with 20 years of service at in 2011 are not in the DC plan and continue to have a DB plan. But those with 15 to 19 years at the time of reform are less likely to have a large DC balance at the time of retirement as future pensioners are expected to have, who will have spent all or a majority of their careers in the hybrid plan.

Mr. Crowley inquired as to whether Mr. Newton's calculation for the expected social security portion of post-retirement income accounted for the government pension offset and windfall elimination provisions. Mr. Newton responded in the affirmative, but clarified that calculations were based on an employee in social security for the entirety of their career.

Mr. Atwater inquired as to whether increased turnover has had an impact on the pension plan. Mr. Newton testified that assumptions have adjusted for increased turnover going forward.

Chair Nee then called William Forde, New England Pension Consultants ("NEPC"), to provide an overview of the state's pension investments.

Mr. Forde began his presentation with a discussion of Rhode Island's discount rate. Rhode Island's assumed rate of return is 7%. This assumed rate of return is consistent with that of mid to large public pension plans, which maintain a median assumed rate of return of 7% and an average of 6.93%. In the last decade, assumed return rates have tended to decrease across states, Rhode Island's included.

Over the trailing 10-15 year period, Rhode Island has maintained a 7.1% return rate, exceeding the 7% return assumption despite a range of returns in any given fiscal year. These results place Rhode Island in the tenth percentile of its peer universe, outperforming 90% of its peers.

Mr. Forde testified that asset diversification and private market investments have been a meaningful contributor to the state's pension returns. Lower liquidity assets like private market investments provide a premium over public market peers, and have been a key diver in Rhode Island's return rate. Indeed, five- and ten-year plan performance has exceeded public market benchmarks, such as a traditional 60% stock, 40% bond split and even a more aggressive 80% stock, 20% bond split.

However, Mr. Forde testified that changes to the benefit structure that result in increased negative cash flow will likely require the fund to reduce private market investments, and may therefore reduce future investment outcomes.

Rhode Island's pension plan currently maintains an attractive negative cash flow profile relative to other public pension plans. This cash-flow profile permits the state to consider the private market investments that have been productive for the plan. Such access to private markets and ability to manage cash flow on a monthly and quarterly basis has proved a challenge for pension plans with

larger negative cash flow, requiring such plans cut into the corpus to make benefit payments. If the state does enact changes that negatively impact the fund, then Mr. Forde testified that he expects the expected return rate to be lowered accordingly.

In response to an inquiry from Mr. Atwater, Mr. Forde testified that higher negative cash flow is typically an in impediment to investment results, thereby increasing the required contribution rate to keep the fund size stable. Consequently, the fund would be more expensive, since increased state contributions would need to cover the gap occasioned by lower returns.

Finally, Chair Nee called Thomas F. Huestis, Public Resources Advisory Group ("PRAG") to provide an assessment of the state's finances and bonding capacity relative to the Rhode Island pension fund.

Mr. Huestis testified that there are three ratings agencies that assess Rhode Island's credit worthiness: Moody's Investors Service, Standard & Poor's ("S&P"), and Fitch Ratings ("Fitch"). In preparing their assessment, each rating agency considers the state's economy, financial performance, governance, and long-term liabilities. Long-term liabilities, including debt, pensions, and other post-employment benefits ("OPEBs") have become a focus for ratings agencies since the Great Recession.

Generally, ratings agencies have a favorable view of Rhode Island. However, each agency consistently emphasizes the state's weak economy and demographics, both of which constrain the state's ability to increase its rating from present levels. Each ratings agency has also considered long-term weaknesses in the funded status of the state pension system an important factor.

Historically, Moody's revised its outlook on Rhode Island from 'stable' to 'negative' just before pension reform, citing the "rapidly escalating pension costs . . . (which are) set to double in two years . . . raising the likelihood that it will . . . fail to achieve the fiscal breathing room needed to sustain a financial position commensurate with other Aa2-rated states." A report issued after RIRSA's introduction several months later remarked that "pension reforms . . . would be credit positive for Rhode Island."

Currently, Moody's has assigned Rhode Island an Aa2 rating. This rating is driven by economic and demographic factors, but pension liabilities are a notable factor as well. In its last rating report, Moody's continued to express concern over high pension and debt liabilities, despite recognizing the positive effects of pension reform.

S&P has notched the state's rating down to an AA due to an observed history of slow economic and demographic growth, cyclical economic contractions, higher service demands, and relatively low pension and OPEB funding positions. Concerning pensions, S&P stated that Rhode Island has improved, but relatively low pension funding ratios and views pension funding discipline "only as adequate."

Fitch has scored Rhode Island's long-term liability burden factor a level of 'aa,' noting that "[p]ension obligations exceed outstanding debt, driven in part by past funding practices and the state carrying a sizable share of teacher liabilities." Notably, however, Fitch improved the state's

outlook, from "stable" to "positive" based in part on pension stabilization measures introduced a decade ago that "suggest a potentially material improvement in the long-term liability trajectory."

When Rhode Island's ratings are compared to its peers, states with unaddressed pension challenges generally have poorer ratings. This suggests a correlation between lower-funded pension plans and lower ratings and is evidence that pension health remains an important consideration in a state's credit outlook.

Absent pension reform – and assuming that the state continued to make the ARC contributions – the state would have had additional $3 billion pension expense over the past 12 years and the state's UAAL would have remained stable. An additional pension expense totaling $3 billion over the last 12 would have been a significant burden on the State which would stressed the state's rating. Furthermore, had the state failed to meet the increased the approximately $3 billion in ARC payments, it likely would have had a meaningful negative impact on the state's long-term rating.

In response to a question from Mr. Crowley, Mr. Huestis indicated that ratings agencies are quick to downgrade, and that it takes a relatively long time to re-establish its former rating. Mr. Newton added that ratings agencies are less concerned with the nature of a change itself, and more concerned with how it is implemented. For example, if the state enhances benefits and re-amortizes the debt over a longer period of time – so that current contribution levels remain unchanged – it would present a considerable concern to a ratings agency. But if the state enhanced benefits and there is a corresponding increase in contributions, ratings are less-likely to change. Mr. Huestis agreed with Mr. Newton's assessment.

Mr. Huestis then addressed the impact of pension reform from a debt affordability perspective. State law requires the Office of the General Treasurer prepares a bi-annual debt affordability study, assessing the state's ability to meet its outstanding debt obligations. Under state law, debt affordability not only considers tax-supported debt, but the state's pensions and OPEB liabilities as well.

The last debt affordability study – issued in 2021 – indicated that pensions-related liabilities have not caused the state to exceed its debt capacity. But if the state had not enacted RIRSA, the state would have consistently exceeded long-term affordability limits. Looking outward from 2023, the state would have exceeded recommended limits on tax supported debt service through 2028, and on tax supported debt through 2025. Mr. Huestis noted this assessment likewise assumes Rhode Island continued to meet its ARC payments and that the UAAL did not meaningfully change. This means that the state would not have had any debt capacity until 2028 with constraints in debt capacity in many years thereafter but-for pension reform.

Mr. Huestis further testified that negative credit action would impact other governments' municipal borrowing too, because many of the municipal and quasi-state issuers' ratings are based on the state's rating. This would mean the cost of capital for municipal building projects – such as school construction – would be higher as well.

Chair Nee announced the next meeting will occur Thursday, November 30, 2023, at 4:00 p.m.

Chair Nee called for a motion to adjourn the meeting.

On a motion duly made by Mr. Atwater and seconded by Ms. Quinby, it was:

VOTED: THAT

	The Pension Advisory Working Group adjourn the meeting of November 02, 2023
VOTE:	9 members voted in the affirmative by voice vote and 0 members voted in the negative.
YEAS:	George Nee, Eric Atwater, Patrick Crowley, Brian Daniels, Thomas Huestis, John P. Maguire, Laura Quinby, Jennifer Slattery, and Edinaldo Tebaldi.
NAYS:	0
ABSTAINS:	0

The meeting adjourned at 6:27 p.m.