[LR452 LR518]

The Committee on Nebraska Retirement Systems met at 9:00 a.m. on Tuesday, November 20, 2012, in Room 1525 of the State Capitol, Lincoln, Nebraska, for the purpose of conducting a public hearing on LR452 and LR518. Senators present: Jeremy Nordquist, Chairperson; Lavon Heidemann; Russ Karpisek; and Heath Mello. Senators absent: LeRoy Louden, Vice Chairperson; and R. Paul Lambert.

SENATOR NORDQUIST: Welcome to the Retirement Systems Committee. I am State Senator Jeremy Nordquist, Chair of the committee. I represent District 7, which covers downtown and south Omaha. Today we have two hearings. This morning's is on LR452 and it's our annual interim study to examine the Public Employees Retirement Systems administered by the Public Employees Retirement Board; and this afternoon we'll be hearing LR518 by Senator Mello. Just reminders, if you are testifying, there are testifier sheets in the back. Please fill those out and turn those in to our committee clerk; please silence cell phones. It's been awhile. Is there anything else I need to remind them of? Please state and spell your name as you come forward. And our committee staff: to my far right is Laurie Vollertsen, our committee clerk; to my left is Kate Allen, our legal counsel; and I will let the senators introduce themselves.

SENATOR MELLO: Heath Mello, District 5, south Omaha.

SENATOR KARPISEK: Russ Karpisek, District 32 from Wilber.

SENATOR HEIDEMANN: Lavon Heidemann, District 1, southeast Nebraska.

SENATOR NORDQUIST: Great. And Senator Heidemann told me this morning that we can just take the funding out of the university budget to fund any shortfalls in our state pension plans. (Laughter) That was very generous of him, so. (Laugh) The first thing we are going to hear this morning is the compliance audit that was conducted. It's statutorily required every four to ten years. We have Melanie Walker from Segal and Dave Powell from Groom Law who will be presenting the findings of the compliance audit. So please come forward and we welcome you. [LR452]

DAVID POWELL: Thank you. [LR452]

SENATOR NORDQUIST: Thank you. [LR452]

DAVID POWELL: I'll just go ahead and introduce myself. I am David Powell, that's P-o-w-e-l-l, principal with the Groom Law Group in Washington, D.C., a pensions boutique firm. [LR452]

MELANIE WALKER: And I'm Melanie Walker, that's W-a-l-k-e-r. I'm from the Segal Company in...actually in the Denver office. [LR452]

SENATOR NORDQUIST: Great. Thank you. Please begin. [LR452]

MELANIE WALKER: (Exhibit 1) Okay. Well, I think we want to start by making sure everyone has one of these reports. We'll kind of go through that and highlight a few areas that we feel are important. I want to start with just kind of describing the process that we went through to do the compliance audit. It is three main phases. One is an information gathering phase where we asked the retirement system to provide us with all of the documents that govern the plan and guide the actual administration of how they operate the plan. We review those in great detail to learn about the plan and to kind of match up what the plan documentation says the plan will do and what the operational documents say the plan will do. That's phase one. Phase two is an on-site interview with the system, and we interviewed a number of people from the system about all aspects of administration of the plans. And I should back up a little bit. We actually reviewed the school employees' plan, the judges' plan, State Patrol plan, which are defined benefit plans, and then the state employees' plan and the counties' plan and then as well as the deferred compensation plan, so I'll kind of refer to those as plans altogether or distinguish them. [LR452]

DAVID POWELL: And also, by way of explanation, we follow the IRS way of dividing plans up, and for both the state employees and counties we considered the cash balance plan to be a defined benefit plan and really a part of...combined with the defined contribution plan. So we consider those as one plan for our purposes, for legal purposes, even though for your purposes you may consider those to be two plans for each of those. [LR452]

MELANIE WALKER: Thank you, David. So on page 2 of the report kind of lists the main personnel that we interviewed at the system. We used an extensive list of questions to go through and hit every aspect of administration and legal compliance. That's phase two. And then the third phase is a drafting of this report. We provide it to the system and get their comments so that we ensure that we understood what they told us, that it matched up with our understanding, and provided a final report to the Retirement Board. And then we're here to visit you fine folks today to talk about this as well. So the first important aspect of the report is that we found that the system and all plans under the system were substantially in compliance with IRS rules and other federal laws. And then throughout the report we have highlighted some issues that relate to plan documentation as well as operation of the plan that are minor defects or areas that could be improved for best practices, and that is the basis of our report. And I'm going to let David talk a little bit about the plan document issues first. [LR452]

DAVID POWELL: Sure. And by way of explanation, the IRS has a number of highly technical and complicated requirements that apply to retirement systems; and they expect that all retirement systems, and all pension plans really, are in compliance with those all the time, both in form and in operation. And I think it would come as no surprise that that's really impossible. I often say that these rules are so complex that every pension plan in the United States is not in compliance with some aspect of these at all times, whether they know it or not. It has become so common that plans find minor wording issues or minor compliance issues that, in fact, the IRS has published repeatedly a thing called "The Employee Plans Compliance Resolution System," which is a sort of simple and speedy way of doing the corrections, so that you can make the correction and move on. So in that regard, we found a few minor wording issues concerning some arcane IRS limits that we advise some changes be made, and in fact they, I think, already largely have been made. And then there were a few minor operational violations which we can explain in more detail. Before I get into the plan document changes, the first thing I want to address--and I believe that it begins on page 4 of the report, if you refer to that--concerns the participation in the systems of certain entities that are sort on the fringes of being governmental. And I should also sort of note parenthetically that a lot of the things I talk about today are really new developments since we did this review ten years ago. The IRS has been particularly active in the last ten years in public plans, as you may know, and in fact several years ago held a town hall for public plans to meet in Washington, D.C., where they described public plans as an underserved area. And one of the things that they have begun to look at is a very old question of exactly who is entitled to participate in a governmental plan and receive the benefit of many of the exemptions from Internal Revenue Code requirements or special rules that are extended to public plans. And the IRS has in fact recently put out a notice of proposed rule making, so they were aware that it would already be so controversial that they didn't propose a rule; they put out a notice that they were thinking about proposing a rule that included the rule they were thinking about proposing. And it is on this very subject of what is an agency or instrumentality of a political subdivision of a state that is entitled to have their employees participate in plans. In looking at the Nebraska plans, we noticed two areas that sort of deal with what I refer to as being on the fringes of being governmental that raise some question. One was the Stuhr Museum and its employees and whether they are sufficiently governmental, and another was various county authorities which are related to the counties but not actually part of the counties. Now the question of whether those entities are entitled to participate in a Nebraska system has two prongs. One is, what do the Nebraska statutes say? You know, do they say that they're permitted? And there was some uncertainty there because the statutes say that you have to be a county employee to participate and it wasn't entirely clear that the employees of those entities were county employees. The second question is whether the IRS would agree that those are governmental employees for this purpose, at least with respect to the IRS. Because there's still this early rule-making stage and various versions of this rule might even allow small numbers of nongovernmental employees to participate in public plans, we wouldn't advise making any changes on account of the IRS rules at this point but that you should continue to monitor. But it's a separate question as to whether some of those employees are county employees for purposes of state statute so as to be permitted to participate. So we noted that issue. The next piece I want to talk about is really the plan language, and this is one of the things that the IRS concerns itself with the most and it's also an area that has changed a great deal since the last review was done ten years ago. The IRS used to be fairly lenient on when plans were amended, when they had to be amended for changes in the law, for changes in the regulation, whether particular words were sufficient or not. And when you applied for a determination letter, if they thought that something needed a little clarification--they disagreed with it or thought something ought to be added--they just asked for it and you gave it and you moved on. The IRS rethought that in 2007 when they issued a revenue procedure that says that not only are plans generally expected to file on an every-five-year filing cycle with the IRS, including public plans which were assigned to a specific cycle, but they also began enforcing rules on when plan language had to be updated for changes in the law. This has been a very contentious point with public retirement systems, as you can imagine, because public retirement systems, you don't just go to the senior VP of HR and have them sign the amendment. It's a lot more complicated than that; it takes a lot more time. So the IRS has begun to enforce those rules more strictly, look at exactly when changes in the law are reflected in even public plan statutes and rules. And with that in mind, knowing how the IRS has changed in this, we looked at all the various requirements. I mean the IRS actually issues now a very lengthy thing called a cumulative list which numbers all the code sections, changes in regs, everything else; it says exactly when they need to be adopted by, with some special rules for public plans again. And we went through, in that regard. We found that at least for two of the plans some of the language looked to be late, the way the IRS refers to it. The language is nonsubstantive. As is often the case with IRS language, it doesn't have any significant impact on your operation of the plan. For example, this happened to involve the 415 limits, which are maximum limits which you weren't hitting anyway, so there wasn't any actual violation. It's just the magic words were not on the page as far as the service was concerned. But again, under EPCRS there's a very simple way to file and correct that and we'll undertake that. And we have a few other provisions which, you know, we noted needed to be made and...but we're still within the time for making them, and the system did pass the bill to make those changes. The IRS is in the process still of reviewing the systems for the determination letter filing we made in 2008, so, yes, that is almost five years. In fact, that was made in Cycle C in 2008. Cycle C begins again next year in February. We may be near the process. The IRS has in fact asked for questions about much of this plan language, which we go into detail on in, oh, on through page 11 or so, and we'll be responding to them yet again, with the assistance of Jason and Phyllis. And if we're lucky, we'll have another determination letter for the plans, after we've answered all our questions, before we have to file again next year. That is what I wanted to say about the plan language. There is one last point concerning some IRS developments in "pick-up" contributions, and this in fact is a piece that begins on page 9. And what this has to do with again is an issue that has popped up since the last review ten years ago, although I may be sounding like a broken record referring to that. But the IRS, in its wisdom, issued a ruling in 2006 which dealt with the area of salary reduction contributions being treated as pretax for purposes of public retirement system. These are known colloquially as "pick-up" contributions. They're treated as employer contributions. So from the IRS perspective, employer contributions are pretax. Employee contributions is akin to an employee writing a check; that's after tax. One of the things they said in that is some language concerning the proper authorization of those "pick-up" contributions, and they need to be authorized by the person duly authorized to take such action with respect to the employing unit. The IRS has not, however, clarified whether for purposes of a public retirement system, where you're dealing with individual employers, say county or schools, whether state statute is sufficient to effect that when the actual employer, the entity with the payroll, is the local employing unit. We think that it does, although we think that the way to bolster that is to have legal support under the laws of the state that say, for example, through an Attorney General's Opinion or otherwise, that the state has the authority to designate those as employer contributions, typically using the magic language from the ruling, on behalf of all the employing units. And that sort of completes the link there. We think that it is highly unlikely the IRS is going to challenge state law on that. We do note that. And one of the things I'll also just add into that because it's going to pop up later is another rule they slipped in to that 2006 ruling was that any one-time elections to participate or not participate, in order to satisfy being treated as employer contributions for that rule, have to be made within 30 days of the employee first being able to participate, by election or otherwise, in any system. And I'm going to get back to that because there are a couple of particular areas where certain employees might have been able to do that, which we raise as an issue later on in the paper. But so having finished with those plan language and "pick-up" issues, let me turn it back over to Melanie to talk about missing participants. [LR452]

MELANIE WALKER: Thank you, David. Yes, I'm going to highlight a couple of operational issues, the first one of which is a process for locating missing and unresponsive participants and beneficiaries. Obviously, that's an important issue as far as trying to find people and give them their benefits, but from the IRS standpoint the tax rules require that someone who is no longer working must begin to take their benefits by approximately age 70.5. So there is actually an IRS rule that requires that you find and look for, make a due diligence effort to look for those missing participants. And in the course of our interviews with the system, we found that they did have a thorough and reasonable process for finding missing participants but that that had not been put down to paper in a formal written process. So as part of this report, we described sort of the best practices from an ERISA standpoint, because that's where most of the guidance from the federal government comes from, not from the IRS but actually from the Department of Labor on how to find missing participants. So we kind of went through in the report what's the best practice, and then we made some recommendations about areas of the process that we think is important to put in a formal written process. I won't get into the details of that, but for the most part the system is using a locator service, which is the most common way to do that. There are some other methods for finding missing participants that are available as well. And I actually want to highlight one that went away between when we did this report and today. The IRS used to have the letter-forwarding program that you could use to find participants that were missing, and you sent a letter to the IRS. They, in theory, would forward it on to that person, because they had a good address. And the IRS recently has come out and said that this process, while still available, is not due diligence in finding missing participants. So their own process is not good enough. (Laugh) So just wanted to highlight that that's changed from what we wrote in this report months ago. The other two issues that I want to talk about next are very minor tax notice issues about how the system notifies participants of their, you know, the tax implications of what they do with their benefits. One is a notice that describes basically how you roll over benefits. And we've provided the model from the IRS to the system and they've made some minor changes, so I think that is a, you know, an area that has already been taken care of. The other area was that the system used to remind people, who are receiving a monthly pension check, once a year that they have a right to change their withholding, and that they must ensure that withholding is made on persons living abroad. And they've...it is our understanding that they've already also handled that issue as well. Okay, so now we're on page 14 of the report and I want to just talk briefly about what happens when a participant dies between the time that they leave employment and apply for the benefit and actually start receiving it. There's always a little bit of lag time in administration figuring out the details of their benefit. And there was some uncertainty, both in the language of the plan and how those situations are actually handled in operations, whether if a person files for a benefit and then dies before they receive it, is that treated as a preretirement death so that certain types of benefits are available, or is that a postretirement death so that other types of benefits are available. And it is up to the discretion of the plan to determine which one they'll do. They just want to do...you just want to do it consistently and keep in mind which is, you know, better for participants. We noted in our report that for public systems the most common way is to treat a situation like that as a preretirement death because it affords the most benefits to spouses and survivors. Another item that I want to highlight is...it's a little bit outside of the area of expertise of this compliance review, because we really focus on complying with federal law and being consistent with your written plan documents. But we noticed that, in the course of our review, that this is a very large system, lots of members, fairly complex with the different types of plans--defined benefit, cash balance, combined with a defined contribution plan. And that although we note that the staff is doing a very good job of administering the benefits, that it may be worth reviewing whether the system is using technological resources to the best of their ability--automation, outsourcing to their third-party administrators, particularly on the defined contribution plan, which is individual accounts. And again, this is not my area of expertise on whether you're using technological resources to the best of your ability, but we did notice there were a lot of manual processes that rely on one person knowing exactly what they're doing, which maybe the person right now knows what they're doing. Is that going to continue in the future? So we just made a brief note to consider reviewing that aspect of plan administration, whether there are better ways to utilize technology in that area. And then the next couple of items on employee communication and contributions are very minor, so I'm not going to spend time talking about them. They are really how to update plan handbooks. And just by discussing them with the system, we feel that that issue has now become a nonissue, so to speak. The next section of our report talks about specific issues that affect the defined benefit plans for school employees, judges, and State Patrol, and the first one David has already touched on. We talked a little bit about the 415 limit plan language, which is a dollar limit that is the maximum amount of annual payments that can be made from a defined benefit plan, and he talked a little bit about what language is needed to pass IRS muster. And we noticed, in the course of our interviews, that the system does not have a formal testing process and that's likely because they don't have participants meeting that annual dollar limit currently. That said, if the IRS ever comes knocking on an audit, you want to be able to show that you've at least looked at this issue on an annual basis and ensured that that continues to hold true. So that was our recommendation in that area, that you have some minimum level of 415 testing just to kind of make sure you're in compliance with that every year. And I think... [LR452]

DAVID POWELL: And it is a real bugaboo with the Internal Revenue Service for public plans and for other plans, as it would be a certainty if they were to audit that the first thing they would ask for is where are the 415 testing rules. And again, those are maximum limitations. They're subject to a lot of special quirks and actuarial equivalence rules, but because they're maximum limitations it's highly unlikely that you would have violated it for anybody. But being able to show compliance with it is something that the IRS is certainly expecting these days. And one of their particular areas of concern for the last few years has been DROP accounts, and we looked at the DROP provisions of the Nebraska plan. We did find that exactly how they work from an administrative perspective and how that folds into sort of a tax analysis of how they comply with the tax laws was not entirely clear under the statute and regulations. It does appear that what happens is that the amounts that would have been paid as an annuity during a DROP period go over into defined contribution accounts of a particular type, 401(a), which is all just fine, you know, theoretically; and there's actually a code section specifically for combined plans that are part DC and part DB. It's that 414... [LR452]

MELANIE WALKER: (k). [LR452]

DAVID POWELL: ...(k) which is, in fact, what your county and state employees combined--old DC, new cash balance--are. The question is how those are tested for 415, because there's actually different limitations for defined benefit and defined contribution plans. And the IRS hasn't given much guidance in the area. In fact, they would probably describe themselves as currently studying the area. It's generally not a good idea when the IRS is studying something that you're doing. And in fact we know from many other systems that they are actively studying exactly how those work. We do have an idea of how the IRS is likely to perceive how these work, and that would be that each transfer out of the defined benefit plan to the defined contribution plan at the time of the DROP is not a contribution to the defined contribution plan but, in fact, is a distribution to the defined benefit plan. So actuarially you sort of have to add all these things back together and come up with one number and test that against it. But it did not appear that was being done and so our recommendation really was twofold in this regard. One was to clarify the structure of how DROP works, and there is a structure in terms of how it's actually working but it's not that clear under the statute; and also that that 415 testing also be undertaken. So it was part of the general recommendation that 415 testing be done for the DB systems generally. [LR452]

MELANIE WALKER: Okay. The next issue that I want to highlight is described on page 18 regarding the review of information that the system uses to calculate benefits under the defined benefit plans. In our interviews, we noticed that the system has a pretty rigorous process for making sure that average final compensation and the amount of credible service is accurate at the time of retirement when they're looking at calculating the benefit, but there's really no process in place for a regular check of that information as you go along. So you can imagine that someone is working, you know, 10-, 20-year period. No one is looking at whether that credited service, the hours and the contributions that are reported and the compensation, is what you would expect; you know, that there's some sort of consistency. So that when it gets to time for retirement, if there's problems, it's difficult to correct it at that time. Really, that has in practice been a problem only with the school employees' plan, not so much with the State Patrol and the judges, mainly because in the school employees' plan you have a large number of employers sending lots of contributions on different people that change. They flow in and out of the system. And this becomes important, because under the IRS rules for a defined benefit plan it's a very basic rule that what the plan is promising is a benefit, a formula what they will pay out. It does not matter whether the contributions to pay for that benefit have actually been made. The plan is still responsible for paying that benefit to satisfy the IRS rules. So that highlights the issue and makes it very important that the plan is working with the employers to make sure that contributions are coming in when they're expected. And if you have a problem at retirement, it's a little bit too late to fix that problem. It's very difficult, as you can imagine. So we highlighted this as an issue that the system may want to consider doing some regular auditing and checking of employer contributions, the salary and hours that are reported on these, particularly on the school employees' plan, and that in some ways that they develop processes for how to fix it if they find a problem. And it's better if you find the problem two years into it rather than much further down the road. And there are ways to fix it. You just want to formalize a process for how you do that. And a lot of it is communication with the employers, making sure that they understand what is expected from them as far as reporting accuracy. And when you start catching them doing it wrong, they start to do better. (Laugh) So the next issue that I want to highlight is, again, a nonissue from now. When we looked at this and did the report, there was some IRS rules about what could be a permissible normal retirement age. For a public plan that's really only important if you allow in-service distributions at normal retirement age, which this system does not. And eventually the IRS came around to our way of thinking, so to speak, and said if you do not provide in-service distributions before age 62 in your public plan, you do not even have to define a normal retirement age. And so that kind of took place between us writing the report and finalizing it and reporting to this group, so that it is no longer...the plan...some of the plans did not have a normal retirement age and now it looks like that it's not necessary, so. [LR452]

DAVID POWELL: Pending further IRS guidance. [LR452]

MELANIE WALKER: Yes. (Laugh) [LR452]

DAVID POWELL: The next issue I want to get to is...and actually this is changing to Section 3, issues affecting the DC plans and the cash balance plans, and I'm on page

20 at this point. This gets into something which I had flagged before, which is this somewhat troublesome IRS revenue ruling that came out in 2006 which purported to put stricter limits on the ability of employees to make elections to participate in or not participate in public plans. Before this revenue ruling there were lots of private letter rulings, which no one can rely on other than the person they're issued to, that blessed all sorts of "pick-up" arrangements, even right near retirement for public plans. But the 2006 revenue ruling signaled that the IRS was rethinking that and actually had rethought it. They were rethinking it for several years prior to that. The issue is that, for arcane historical reasons, public plans, governmental employers are not permitted to have 401(k) plans. It's forbidden under the Internal Revenue Code. And a 401(k) plan is actually what's known as a cash or deferred election. It is any opportunity of an employee to take taxable cash as opposed to a nontaxable, tax-deferred plan contribution. So thinking about that conceptually and very expansively, the IRS started to be concerned that these "pick-ups," where the employer in the public plan context is taking the money out of the salary, pretax, and putting it into the plan, has the potential for being a de facto 401(k) election, which is evil. It's not permitted. It's not actually evil. It's just, again, historical; because at the time they were extending 401(k)s to nonprofits and they went to the governmentals and they said, you guys want 401(k)s? They said, oh, we don't need it because we've got 457(b)s and 403(b)s and things like that. So they never extended it to governments. But now the way the IRS looks at it, if you trip across that inadvertently you've basically blown up your plan. So they take it very seriously. And one of the things they added, really for the first time in this 2006 ruling, is this rule which I sort of quote in there, that it has to be made no later than the employees first becoming eligible under the plan or any other plan or arrangement of the employer, and they've sort of read a bit of a 30-day imposed hire rule into that. So that raises a couple of concerns. One is under the state employee and county plans, permanent part-time employees who have attained the age of 20 years may exercise the option to begin to participate in the retirement system. That has not been limited. I mean, that has been treated as a one-time revocable election, but it has not been limited to the first 30 days of meeting that eligibility criteria. And I think that the IRS

would have a problem with that, and so we raise that as something that is worth correcting. I would note, and I did note in the parenthetical down there, that there are public plans which have been trying to have that rule made more lenient, still the one-time revocable election but not necessarily made at the first time that you're basically hired but later. And, in fact, there's been some reporting in the press of that because a number of the public plan changes where they've wished to give employees an election to continue in an old plan or go to a new plan, particularly in California, have run afoul of that rule and have not been able to get rulings from the IRS that that's permitted. So there may be efforts to change that. It's too early to tell. And I'll turn it to Melanie to mention how that works in the correction process. [LR452]

MELANIE WALKER: Sure. Just along that very same line is when an employee in a state or county plan is found to have missed contributions over a period of time--they should have been an eligible employee but they weren't reported as such--that they are given the opportunity for up to two years back, you know, in reverse, to make up those contributions. Well, as David mentioned, that very much looks like a cash or deferred arrangement--a 401(k). They should not be given the individual election to choose. It should be that they are required to make up those contributions. And we actually even recommended that you consider extending the period of time more than two years. Of course, there's other considerations, in that whether that becomes burdensome on the employee to make up a long period of contributions that have been missed when essentially it's not their determination of whether they're an eligible employee or not; it is the employer's. So that is another issue that the IRS we think would have a problem with if employees have...they can decide whether to make up those contributions or not. It's an election. Did you want to talk about forfeitures next? Do you have more on this... [LR452]

DAVID POWELL: Yes. [LR452]

MELANIE WALKER: Okay. [LR452]

DAVID POWELL: We're now moving to a question of what's called the exclusive benefit rule in IRS terminology, beginning on page 21. The background of the question that was raised here is that the IRS has a longstanding rule that does apply to public plans, and it predates ERISA so it's well before the '70s. I don't know how far it goes back. But it is that assets held in trust in one of these tax-qualified plans have to be held for the exclusive benefit of the participants and beneficiaries of that plan. So however you divide up your plans, those plans have to respect those assets for the participants and beneficiaries of that plan. Two particular areas of interest in this is one is forfeitures. When an employee, you know, leaves employment before they're vested, those amounts forfeit; and those amounts, the forfeitures, need to remain within that plan. There's also the question of expenses and that plan's assets can only be used to pay the expenses attributable to that plan. And you can do reasonable allocations, because obviously some things are not cut and dried and need to be allocated among the plans. And there actually is in the ERISA area, under the Department of Labor, which doesn't have jurisdiction over you but has jurisdiction over private plans, a great deal of guidance on what are reasonable expenses that can be charged to the plan, but it does have to be...those plan's assets have to be restricted to the use of that plan. It didn't seem to us that the statute was really that clear that the funds that comprised the forfeitures remained within those plans, because those don't go back out, they have to stay within that plan, and also that the expenses are limited to being attributable to those plans. And we did think it was advisable that that be clarified. There didn't seem to be any violations in operation that we saw. And one other wrinkle on that is that in the defined contribution plans...or in these forfeiture accounts, in a defined benefit plan there's really no direct connection between your pot of money and the benefits you've promised people, so you can have forfeiture accounts under that remain in perpetuity. In a defined contribution plan there's a separate rule which says that it's in the nature of defined contribution plans that all assets are allocated to individual accounts. If you have amounts that have been forfeited or sometimes you have amounts that are not allocated for other reasons--there might be some rebate of expenses or fees or something like that--those expense accounts that are in no particular participants' accounts have to be zeroed out by the end of the plan year. So in fact you have to use those...any forfeiture...and it can be used to be reallocated to participant accounts, it could be used for expenses, but it has to be zeroed out one way or the other in defined contribution plans by the end of the year. And so we noted that. Melanie. [LR452]

MELANIE WALKER: Yeah. There's one very minor issue remaining on the state and county employees' plan, is that at the time that we did the interviews and wrote the report it looked like there were some court clerks, noncareer court clerks of the Nebraska Supreme Court that were not participating in the plan, although by statute it was clear that they should be. And so we highlighted this issue. And at the time we were writing the report it seemed that the system had worked with the courts to figure it out and get those employees into the plan. So again, it's one of those issues we highlighted and action has already been taken to correct it. And then shifting to the final section of the report on the deferred compensation plan, do you want to talk about the language correction part of it (inaudible)? [LR452]

DAVID POWELL: Well, one of the things I really like about 457(b) plans is that there is this language. It's in Section 457 and it's between 457(b) and 457(c). It's not in either one; it's between them. It's called...we call that the "flush language" because it goes flush to the page, because it's not actually sort of anywhere. But it is a Internal Revenue Code provision. And that "flush language" in 457 between (b) and (c) says essentially that if there is any violation of any of the tax rules with respect to a 457(b) governmental plan, it can be corrected up to 180 days after the IRS notifies you that there is an error. Because of that, 457(b) plans are particularly easy to deal with. And we did note a few areas we would update the language in the 457(b) plan, many of which again, because the 457(b) regulations were updated within the last ten years, but there's a new rule permitting deferrals from the last paycheck that occurs after you terminate employment and certain other unused leave, but not severance pay; and we recommend adding that. There was a provision that the...for purposes of a particular catch-up limitation, it couldn't apply after age 70.5. We did recommend...there is this very complicated catch-up contribution under the 457(b) that's determined actually on the basis of how much underused limit you have for the whole history of your participation, and because very few people know that history, it relies heavily on the participant. But we recommend that there probably be some verification by the employer of that amount to make sure that it's accurate. So this really is taking some steps to make sure that the participants are not gaming the system there, although it's not a huge catch-up election. And then there's a...if you take an unforeseeable emergency distribution, there's supposed to be a six-month holdout for further elective deferrals under the plan, and we recommend that that be monitored to make sure that that's enforced. It was in the plan but it wasn't being monitored--a very minor thing that if there are excess contributions, that the returns include some income allocable to those. Of course, that assumes that there is income allocable to them. We mentioned FICA, as item 6 on page 25, in particular because it's not really a compliance issue for the system but it is a big compliance issue for the participating employers who on a 457(b) plan are supposed to be paying FICA on the contributions. The IRS perceives that there is widespread noncompliance with that. They audit for it heavily. It's just a good thing to remind your participating employers to be doing because it's a significant amount of money; and the IRS, it's one of the first things they look for in local audits. And last was just to ensure that returning service members who are entitled to make contributions under USERRA be reminded of their rights to also make up contributions under the 457(b) plans, as well as the other plans. So with that, that's the quick review of our 457(b) analysis and our review of these. We would be happy to answer any questions that you all have. [LR452]

SENATOR NORDQUIST: Sure. Well, thank you, Dave and Melanie. Just kind of a broad question: This, you know, as you were going through it, can seem like a pretty overwhelming amount of issues, but as compliance audits go how does this stack compared to others that you've conducted? [LR452]

DAVID POWELL: You want to take that or shall I? [LR452]

MELANIE WALKER: Sure. I would say that this is a fairly common amount of issues. It's actually...I will let David speak on the plan document issues, but it sounds like the plan document statutes are in fairly good shape for a public plan. And as he kind of mentioned, there is no pension plan or retirement plan that doesn't have some errors. Some of the places we noted were fairly minor errors and we really just highlighted today kind of the bigger ones, we thought. And a lot of it was around...not that the plan wasn't doing what they need to but they want to document the process that they're following and also document that they're following their process. So when the IRS comes knocking, you just...when you hand them a paper that says here's our process and here's proof that we've been following it, they stop digging, so. [LR452]

DAVID POWELL: Yeah, and I would concur with that. I haven't done any sort of numerical analysis but I would sort of put this in the upper tier of state retirement systems that we've looked at. Like I said, the rules are arcane and we've marched through a number of issues. I wouldn't characterize any of those as really substantive issues. If it wasn't for the fact that the IRS cared about them, I'm not sure why you would particularly care about them. But the IRS does care about them and I think they're worth dealing with. But this is...every system has issues. Many of these are the same issues: you know, fringe entities on governmental plans, 415 testing. But, you know, overall I would characterize the system as being in good shape. [LR452]

SENATOR NORDQUIST: Uh-huh. Okay. [LR452]

MELANIE WALKER: And I would just add that the fact that you have a process for reviewing the plan... [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

MELANIE WALKER: ...on a periodic basis is just one of those things that I talked about that you can show that we look at this periodically and we make corrections afterwards, so. [LR452]

SENATOR NORDQUIST: Sure. Sure. Uh-huh. Right. Well, the administrative efficiency, I know you said that wasn't your area of expertise but I do have, you know, a fair amount of interest, especially as I know a couple members here are members of the Appropriations Committee, just looking at ways to improve the efficiency of agencies. So that recommendation is based on just your experience working with other plans and... [LR452]

MELANIE WALKER: Similar size and complexity. [LR452]

SENATOR NORDQUIST: Yeah. Uh-huh. [LR452]

MELANIE WALKER: Right. [LR452]

SENATOR NORDQUIST: And it doesn't seem like we're utilizing our technology capabilities? [LR452]

MELANIE WALKER: Well, you know, in our interviews we didn't ask specifically about those areas, so it was more of just a sense of that some of the other plans that I do work with on a very, you know, like day-to-day basis,... [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

MELANIE WALKER: ...that they have a lot of automation,.. [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

MELANIE WALKER: ...and I'm not sure that that's taking place here. I'm not sure that it isn't, as well. It just...it seemed like when we would ask about a particular area, they would describe a manual process that they follow. [LR452]

SENATOR NORDQUIST: Uh-huh. Okay. From your experience, would you...if we're looking at that, would it be like a...looking at best practices in other plans? Is that... [LR452]

MELANIE WALKER: Uh-huh. You know, I think you most likely would want to start as like kind of a broad brush... [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

MELANIE WALKER: ...where you look at your systems and someone kind of looks at how you administer things overall, how you use technology, how you use staff, and kind of start looking at areas that they want to dig in further. And then they could make recommendations, do you want to dig further, or are there very good reasons why you are happy with this aspect of administration and do not want to dig further, so. [LR452]

SENATOR NORDQUIST: Okay. All right. Other questions from the committee? Great. Well, we appreciate your time today, and if we have any follow-up questions we certainly have your contact information so we can contact you there. Thank you. [LR452]

MELANIE WALKER: Thank you. [LR452]

DAVID POWELL: Well, thank you very much. [LR452]

MELANIE WALKER: Yeah. [LR452]

SENATOR NORDQUIST: Yes. Are there any other testifiers regarding the compliance audit? Jason, welcome. Go ahead whenever you're ready. [LR452]

JASON HAYES: Good morning, Senator and members of the Retirement Committee. My name is Jason Hayes, J-a-s-o-n H-a-y-e-s, and I'm legal counsel for Nebraska Public Employees Retirement System. I thought it would be helpful today, following the presentation by David and Melanie, that I go over some of the changes that have been implemented by the agency, and particularly mention the sections of the rules and regulations for the record so in case somebody is reading this in the future they'll be able to pinpoint exactly what's been addressed. A number of changes that have been outlined in the legal compliance audit will actually be presented to the committee in the cleanup bill, which can only be done by changing the plan documents that are actually in statute. So I'll touch upon those areas that we as an agency were able to handle through the rule and regulation process, as well as some changes to the deferred compensation plan document. First of all, I'll go into the missing or unresponsive participants or beneficiary area. That was outlined as an issue that NPERS did have practices in place but they were not codified into a regulation. Those have been put into Title 303 NAC Chapter 9. Those rules and regs are currently at the Governor's Policy Research Office and we anticipate that they will be approved sometime in the next 30 days. With regard to tax withholding for non-U.S. payees to the extent that the non-U.S. payees do not have a chance to exempt from those withholdings, that was put into Chapter 4.007 of Title 303. Language with regard to death before payments commencing were inserted into Chapter 24.008. The compliance audit mentioned the HEART Act amendments. Those were actually put in the last legislative session in LB916. Formal 415 limit testing has been resolved with Ameritas and is currently in place. Review of credible service and final average compensation language has been inserted into Title 303 of the code for Chapter 18. Questions with regard...or the issue with regard to the cash or deferred arrangements regarding missed contribution makeups--those would be situations where somebody went back and said, I was able to make a contribution but I was not allowed to--have been addressed in 303 NAC 18.004. And I'll be happy to provide a report of this later afterwards to the committee. And then with regard to the deferred compensation plan, sections were put in regarding posttermination pay in Section 12 of the plan document. Language was put in regarding the normal retirement age in Section 5(b)(iii)(D). And then finally, allocable net income on return of excess contributions was inserted into Section 5(g). And so...and I've been in the process, working with Kate Allen, in drafting those remaining sections that will fulfill the requirements of the legal compliance audit. [LR452]

SENATOR NORDQUIST: So are all of these at the Governor's Office or just...or have some of them been approved already? [LR452]

JASON HAYES: Yeah. No, that's okay. Half...or there's five remaining that are at the Governor's Office. Chapter 24...or actually...yeah, Chapter 24 was actually on file with the Secretary of State's Office, November 12 of this year, 2012, and Chapter 18 that I mentioned earlier was also on file November 12, so they're halfway in the process. [LR452]

SENATOR NORDQUIST: All right. Thank you. Any... [LR452]

JASON HAYES: And that concludes my testimony. [LR452]

SENATOR NORDQUIST: Thank you, Jason. Any questions from the committee? Seeing none, thank you. [LR452]

JASON HAYES: Okay. Thank you. [LR452]

SENATOR NORDQUIST: Any additional testifiers regarding the compliance audit? Seeing none, that will conclude that portion of our hearing. And are we doing the experience study or are we doing it together? [LR452]

KATE ALLEN: Actuary. Yeah, he does it all together. [LR452]

SENATOR NORDQUIST: Okay, great. We'll welcome up our actuary to present both findings of the experience study that was conducted and the annual actuarial findings on our state plans. Welcome, Dave. [LR452]

DAVID SLISHINSKY: (Exhibit 2) Yeah, thank you, Senator, members of the committee. We have a presentation here broken out into four different parts. We'll go ahead and hand out those presentations for you and then we'll go through that information. Okay. Please turn to page 1. We've been very busy this year. We performed an experience analysis earlier this year on the systems and we'll go over those results, and give you a little background on what we do in an experience analysis. We'll also provide you with the results of the 2012 actuarial valuations for all of the systems: the school retirement system,... [LR452]

SENATOR NORDQUIST: Dave, could I get you--sorry--to state and spell your name so Laurie can get it right in the record. [LR452]

DAVID SLISHINSKY: Oh yeah. Here again my name is David Slishinsky, it's spelled S-l-i-s-h-i-n-s-k-y, and I'm a consulting actuary with Buck Consultants. And we'll go through the actuarial valuation results on all the systems--the school retirement system, the State Patrol system, the judges' system, and the state and county cash balance systems; give you an update on the funding of those systems and the annual actuarial contributions. We'll also talk a little bit about some new changes that are going on in the accounting of pensions, both for retirement plans in the retirement system as well as for employers, and then we'll review some projections. Since the economic crisis occurred, we've been doing 5-year and in some cases 30-year projections of the actuarial results to give policymakers a better feel of the direction of the funded status and the actuarial contributions for the plans. So if you turn to page 3, the purpose of an actuarial experience analysis is to compare the actual experience during a period with the assumptions to see whether or not there has been any significant deviation between what was assumed and was actually experienced. So we typically do this every five years over a five-year period. We take all of that data that we've accumulated from the actuarial valuations and actually compare that information against the assumptions. If there's sufficient data or changes that are material, then we'll recommend an adjustment to those assumptions. Now the future experience is likely to be different, given recent trends, so we take that into consideration as well, whenever we're considering making changes to the assumptions. And this process provides a better measurement of the pension plan's actuarial position and the projected cost of the plan. We use a set of assumptions for purposes of quantifying the amount and value of those future benefit payments, but they're really unknown today. It's unknown really how long people are going to live. We use this data to estimate how long we believe that people are going to live, what retirement patterns are, what withdrawal patterns are, what pay increases are, what investment returns are going to be. And we use that information in developing our recommendations for these assumptions, and they're really a best guess or best educated guess as to what the future experience of the plans are going to be. We feel that they should be appropriately conservative given the fiduciary responsibility of the boards that are responsible for administering the plans; and each assumption should be explicitly reasonable when referring to mortality assumptions, retirement assumptions, withdrawal assumptions, and the investment return assumptions, those kinds of assumptions. What I like to say is actuarial mathematics is a science but its application in the real world is an art, so it's a blend of art and science. We use this information and then it's a matter of using professional judgment when we recommend changes to these assumptions. And there's no right answer. The one thing about this actuarial process--we do it once a year--you're always going to see actuarial gains and losses, which is the difference between what we assume is going to happen and what actually does happen. But this process is self-correcting because those gains and losses adjust the contributions, and as long as you maintain that pace of funding and that pattern of funding along with the actuarial results, the plan should have enough assets over time to pay all the benefits. Turning to page 5, a little bit about the economic assumptions. The inflation is consistently applied throughout all of the economic assumptions used in the valuation of the plan, including the investment return, as well as salary increases, cost-of-living adjustments, and interest rates on the contributions. Real rates of return should reflect the asset mix or the asset allocation, because 92 percent of the investment return comes from that asset allocation decision; in other words, how much of the fund's assets should be invested in equities, how much should be invested in bonds, real estate, or alternative investments. And they should reflect a long payment period. There is a long time horizon for the payments of these benefits, so when we do these valuations, we're projecting out the future expected benefit payments, and that's a long period of time. And we'll actually show you what the projected results are for the school system. Turning to page 6, in looking at the economic assumptions we did note that we are in a lower inflationary environment right now. There are lower interest rates. Although since the economic crisis in 2008 and 2009 there was a bit of rebound in the equity markets in 2010 and '11, there still is a lot of volatility and a lot of uncertainty in the markets that are affecting the short-term investment returns. Now we use an econometric model in developing what we expect future investment rates of return to be, and we used that for this experience analysis, and it's based on modeling economy. So it takes into consideration unemployment, GDP growth, inflation, and interest rates, and models the economy and then, from that, models what the expected market rates of return are going to be for the various asset classes that are used in the investments of the pension fund. So those returns were determined under this modeling and we determined what the expected rates of return are likely to be, based upon this model. Now there are revisions that are being made in Actuarial Standards of Practice. There was a range that was defined that most actuaries use that was a fairly wide range of saying a reasonable investment return rate might be anywhere between 6.5 or 9.5 percent, and those standards are being revised and they're going to a process whereby you go through and you determine what the expected long-term rate of return is. And unless you have some reason to set your assumption above that, you should be setting it at that rate or even lower to account for a margin for adverse deviation. So we've used those standards in the process of determining the expected rate of return for the Nebraska plans. Turning to page 7, the traditional defined benefit plans--the school, the

State Patrol, and judges--and the cash balance plan assets are virtually the same, so we're looking at the assumptions based upon that asset allocation. The expected future rates of return, we're looking at both the inflation expectation and the real rate of return expectation when we're doing the modeling, and the returns and the inflation were forecasted over a 30-year period and then we took that 30-year result and extended it out throughout the benefit payment period. The projected benefit payments for the school were then discounted at the geometric mean of the investment returns; and we also used the rate of return, an actual rate of return in the first year of the fund for FY '12. All of this analysis was done as of July 1, 2011, earlier this year before the 2012 results were known. So since we knew at that time that the returns were 1 percent but we still did not have the actuarial valuations done, we used the previous year's results and then used the 1 percent return for FY '12. And then we matched those against the cash flows to compare the liability, based upon a discount rate, using those projected investment returns, and compared those with the current or the 2011 valuation results. Page 8 shows the asset allocation that was used. It's primarily invested in equities; 65 percent of the funds are invested in equities, 30 percent in fixed income, and 5 percent in real estate. So that allocation is being used in determining the projected expected rates of return. Now turning to page 9, this is the result of that analysis. And when we do this we're projecting out 999 paths of 30-year results, and determining in each year, based upon the economies and the expectation of market performance for those economies, what the expected rate of return will be. And this is a graph that shows the inflation expectation, which is the blue part of the bars, and the red expectation, which is the real rates of return. Now 2012, this is a simulation that comes from that model, there was an average expectation of 6 percent, but we used 1 percent because that was the actual return for FY '12. And you can see that the expectation is fairly low right now, given historical norms, but there is an expectation of improvement in the economy and improvement in the markets over time and that's being taken into consideration when we're setting the discount rate. On page 10 we're looking at the geometric mean. Now on page 9 we were looking at the mean of the results in each particular year, and on page 10 we start cumulating them and showing the geometric mean or average of the returns in those previous years, from 2012 up through the year shown. So this gives a view of the amount of discount based upon the expected rates of return in each of those future years that are applied to the benefit payments in those years. On page 11 shows the projected benefit payments for the school retirement system and this was done based on the 2011 actuarial valuation results and shows the expected payments for each of the fiscal year-ends, from 2012 going all the way out to 2092, and it gives you a picture of the expected benefit payments out of the school retirement system and why it's a long time horizon and we're looking at a long time period when we're setting our assumptions. Page 12, finally then in conclusions, the result of this analysis indicated to us that the returns and the inflation that are currently being experienced today are low. They're expected to improve or increase slowly over time to a more normal environment, probably within five to ten years. But because those rates of return and the current inflation is lower and has an impact on the future benefit payments and investment return, we recommended a reduction in the inflation assumption from 3.5 to 3.25 percent to reflect that low near-term inflation that we're currently experiencing; also a reduction in the economic productivity assumption from 1 percent to .75 of a percent, and that's reflected in pay increases. As I said before, inflation is not only part of the expected long-term rate of return on assets but is also part of the expected future salary increases. And the wage inflation assumption, which is the sum of those two, is reduced from 4.5 to 4 percent. Now the investment returns also are likely to be lower in the near term, improving slightly over time as the economy slowly recovers from what many people have called the great recession. And then we took those projected expected rates of return and we applied those to the cash flow to determine the present value of all the benefits; and by using those returns and the 1 percent return in FY '12, we calculated a total liability--and this includes future salary increases, it includes future service accruals, so it's the projected value of the benefits that would be payable upon retirement for active members--of about $11 billion. And under the current assumption under the 2011 actuarial valuation, the value of total benefits was a little bit less than $10.7 billion, so as a result, we recommended a reduction in the assumption to 7.75 percent to make sure that the amount of the measured liability was at least as great as the liability that would be measured by using the expected rate of return. Turning to page 13, it's a summary of the recommendations. Now even though we recommended a reduction in the investment return assumption for the school, Patrol's, and judges' plan, from 8 percent to 7.75 percent, the decision to make that change is pending further review by the Public Employees Retirement Board to make sure that...this is the most significant assumption that is made and they want a little bit more time to study it to make sure that that's the right thing to do. There was no change recommended in the investment return for the state and county cash balance plans at 7.75 percent; and then inflation, salary increases, and all of these other changes are reflective of the recommendation for the change in reducing the inflation assumption and the investment return assumption. So that's a review of the economic portion of the experience analysis. And now I want to switch over to decremental assumptions. And the decremental assumptions affect what's going to happen to people: how long are they going to live, what are the retirement patterns for actives going to be, what are the withdrawal patterns, termination from employment, pay increases, and those kinds of assumptions. We do look at what's happened over the last five-year period in this analysis and we look for any trends, so we're going to look at the previous experience analysis as well; and if there's any changes that have occurred during the period, we'll reflect those in our assumptions and our recommendations as well. So just as a brief review, turning to page 15, on the school retirement system, that first column under "Current" is a description of the current assumption, and the "Proposed" is a description of what we had proposed in our experience analysis. And all of those changes were adopted, except for the investment return assumption, based upon further review. So salary increases were increased in the near term in the short service but decreased more over time to a level that was lower than the current assumption; and the impact on the liabilities, that expectation is for a decrease in the liabilities for the change in the salary scale assumption. Retirement rate patterns changed slightly, expecting a decrease in the liabilities. Mortality changes, we did note that there were improvements in mortality. There were less deaths that were occurring during the five-year period than our assumption was expecting. Therefore, we recommended an improvement in the mortality tables to 2015 from 2010 with a one-year setback to match the experience and also provide for a margin for future mortality improvement because we are seeing a pattern of continued improvement in mortality and we're building that into the mortality table. Withdrawal rates, we noticed that there were fewer withdrawals than what we were expecting, so we reduced the withdrawal assumption, and that results in an increase in the liabilities. And then finally disability, the assumption was adjusted as well and that provided a little bit of a decrease. On State Patrol, same general process. The salary scale increased in the first part of the salary scale leading to an increase overall in the liabilities to the salaries. Retirement rates were adjusted. People are retiring at later ages and that provides for a decrease in the liabilities. Same change in the mortality. Here again, people are living longer and there was an adjustment for expected future mortality improvement. And there was no change in the withdrawal or disability assumptions used in the State Patrol system. And then finally, in the judges' system, salary increases were reduced from 4.5 to 4 percent per year. That resulted in a decrease in the liabilities. Retirement rates were adjusted, here again judges retiring later, resulting in a decrease to the liabilities. Same impact on mortality with an increase in life expectancy and an increase in the liabilities due to that increased life expectancy. And then no change in withdrawal or disability benefits. So all of those demographic changes were approved by the PERB board and the results that I'm going to go through include all of those assumption changes with the exception of any change in the investment return assumption. Eight percent is still being used in these actuarial valuations for 2012. So on page 19, the only major change in any of the benefit provisions in the school system was an increase in the member contribution rate from 8.88 percent to 9.78 percent, effective September 1, 2012. That member contribution rate is scheduled to remain at that level until 2017, when it drops back down to 7.28 percent. And also just remembering that the employer contributions are 101 percent of the employee contribution, so when there's an increase made in the member contributions there's also an increase that's made in the employer or school district contributions. A little bit about the history, if you look at page 20. We've shown just what the history of returns have been since 1998. You can see a lot of volatility in the market value return. And for the actuarial valuations we use what we call a smoothed asset method where we smooth the investment returns on market value over a five-year period. And when we smooth them, we're reflecting each year 20 percent of that either gain or loss in the actuarial valuation result. So each year there's a new amount that is experienced and those amounts are smoothed over a five-year period. And what that tends to do is take out the amount of volatility that there is in the market value returns and the impact that that has on the funded status and the actuarial contributions. So when you compare the red line with the blue line, you can see that even though the blue line does vary from year, it doesn't vary as much as the red line does; and that just shows that that smoothing method is working. There were a lot of people, and not necessarily here, but when the financial crisis did hit in 2009 there were people that were questioning the difference in the actuarial and market values and were even suggesting reinitializing their actuarial value to market in 2009. But you can see that, you know, there were some returns that were actually experienced in 2010 and 2011 that had an impact on those returns. Page 21 shows the amount of the market value of assets and the growth over time, as well as the actuarial value. So here again it's just a different way of showing the same information just in the amounts of the value of the assets and how the market value does vary over time and how it compares to the actuarial value. Page 22 shows the amount of the deferral of those asset gains and losses in the smoothing method, and you can see through different economic cycles there's either, you know, predominantly gains that are deferred or there are losses that are deferred. Okay, now turning to page 23, what we'll do is we'll run through the actuarial valuation results. I'll go through the results on the school system in a little bit greater detail so you can see what the results are. We are comparing this year's results with last year's results in 2011. And the current methodology for amortizing the unfunded is a level-dollar amortization, so that's much like a house mortgage where you determine what the amortization is over 30 years and there's an annual payment that's the same amount each year. And we, just for comparison purposes, we showed what impact would have on the amortization of the unfunded liability and the additional required contribution if a level percentage of pay amortization were used. In a level amortization of pay methodology, there's a lower payment initially and then it grows as salary increases are expected to grow or payroll growth is expected, and that continues to increase throughout the amortization period. Either method will fully amortize that portion of the unfunded liability over a 30-year period but the pattern of the payments over that 30-year period is different. So just in comparing the present value of benefits, then last year $10.6 billion basically has now increased due to accruals of benefits and interest to $11.3 billion. Normal cost is the value of future normal cost payments or cost of the accruing benefits for active members. So by taking the difference between those two, we arrive at the actuarial accrued liability based on...it really is the amount of the assets that we would expect to have accumulated as of the valuation date to pay for all past service. Then we subtract out the actuarial value of assets, almost $7.4 billion. So the unfunded this year is $2,250,000,000 versus $1,773,000,000. And most of that change is due to the recognition of asset losses, primarily from 2008 and 2009. There also is an increase due to the change in the assumptions, primarily from the mortality table change; and demographic, there were some significant gains from salary increases being less than expected and also for cost-of-living adjustments that were less than expected. So there were a total of about $86 million in actuarial gains on decrements for the school system this year. But factoring in asset losses, the change in the assumptions, and those demographic gains, there were a net loss of about $470 million that increased the unfunded liability from last year, so the funded ratio is dropping from 80 to 77 percent. Then the amount of the normal cost, which is calculated as the cost of the accruing benefit for actives, we add that to the amortization payment for the unfunded liability, so we're amortizing the $2.2 billion, and each base that is created is amortized over 30 years, so that's a total actuarial contribution of $392 million, or 23.27 percent of pay. The expected contributions coming in are $344 million, so that leaves an amount of $48 million of an additional contribution yet to be made. And then we also calculate a contribution to fund the Omaha Service Annuity. That benefit is funded within the Nebraska Retirement System for the Omaha School District Retirement System. And then when Omaha members retire, there is an amount that's transferred to Omaha to pay for their service annuity. This year that amount is $1.1

million, up from $1 million last year. And now just looking at the result of the percentage of pay amortization method, the only thing that changes in that column is the amortization payment on the unfunded. It is less, and it starts out less at the beginning of the amortization period and grows over time. It would be $136 million, for a total contribution of $330 million, or 19.56 percent of pay. And since the expected contributions for the year exceed the amount of that contribution, then at least in the first year there would be no additional contribution required. So moving to the State Patrol, and then I'll just kind of run through this pretty quickly, and I'll start with the unfunded liability, the same general reasoning here that there are asset losses and mortality improvement that increase the unfunded liability, the funded ratio dropped from 82 to 78 percent, and the amortization of the unfunded increased from $5.3 million to $7 million, for a total contribution of $14.5 million, or 56 percent of pay. We're expecting $9.9 million to come in, so that leaves an additional amount of $4.6 million. And a level percentage of pay would reduce the amortization amount and would reduce the additional contribution down to $2.3 million. And finally on page 25, the judges' system, also an increase in the unfunded liability for the same reasons, up to about $11.5 million, and a reduction in the funded ratio from 98 to 92 percent. So the actuarial contribution amount is almost $4.9 million, up from $4.1 million last year; and expected contributions coming in for the year, a little bit less than that at about $4,791,000, so that leaves an additional contribution of $79,000. And then amortizing the unfunded would show that the expected contribution coming in would meet that amortization. Page 26, just a review of the actuarial valuations that we performed on the cash balance funds earlier in the year on the state and the county cash balance funds. Generally, we found the same changes. The unfunded has been increasing due to investment losses or the fact that the fund earnings were less than the 7.75 percent expected. So the unfunded in the state cash balance increased from $48.6 million to $69.3 million, and the contribution increased from 11.28 percent to 11.7 percent. But the statutory contribution rates coming in are sufficient to meet that requirement so there's no additional contributions needed. On the county plan the increase in the unfunded was $15 million to about $19.5 million and the contributions increased from 10.47 to

10.65 percent. And the amount of the statutory contributions are at 11.61 percent, so here again no additional contributions needed for the county cash balance plan. So just in summary, turning to page 28, the experience analysis that we've done covered all of these systems. Any changes in the state and county system will be effective in 2013 and the primary impact on the increases in the unfunded liability or accrued liability for the experience analysis was primarily a result of the change in the mortality tables that improved or extended...increased the amount of life expectancy for the members. The rate of return on the market value of assets was about 1 percent for FY '12, or 7 percent less than the 8 percent assumed, so that created a new loss. When we talk about losses, we're talking about asset losses. And a loss occurs if the rate of return is less than our assumed rate, and there's a gain if the return is greater than the assumed rate. People think in terms of investment gains and losses when if you had a positive investment return you had an investment gain. That's true; but we're focusing on comparing to our expected rates of return. And the recognition of losses in the actuarial value of assets, losses in 2008, 2009, and 2012 are...there's a little bit of assistance from asset gains that occurred in 2010 and 2011, but the net result was a return of about 2 percent, or 6 percent less than the 8 percent assumed. So that's leading to the asset losses that are recognized in the unfunded liability. When the unfunded liability goes up, the amortization payments go up. Now the actuarial value is now 102 percent of market value, so it's still fairly close to market value. But it does show that the market value is less because we are deferring losses in the actuarial methodology. We now have net losses of $113 million, and this is in the school plan, yet to be recognized over the next four years. Now that is an improvement. What's been happening is those initial losses in both 2008 and 2009 have been recognized. Now the 2008 loss is fully recognized with this valuation, so it's included in the unfunded liability. We have one more year of recognition for the loss that was experienced in 2009 and that amount is $356 million that will be recognized next year. So that will have the impact of increasing the unfunded liability next year another $356 million. So it's now at about $2.25 billion; with that increase the expected would be around $2.6 billion, here again another piece added to the unfunded liability next year. And we'll look at some projections and show what the impact of that is. And just a review of the funded ratios: Because of the asset losses and the change in the mortality, those funded ratios have dipped down from last year to this year. There are additional contributions for the State Patrol, the school, and the judges this year under the current methodology set in statute. And the recognition of those investment losses have increased the unfunded liabilities and the contribution rates, but we're near the end of that and we'll show the results of the projections for next year and a few years in the future a little bit later. But now I want to change the discussion to GASB information, and GASB stands for the Governmental Accounting Standards Board, and they set requirements for the accounting of pensions and other benefits for not only retirement systems but also employers. And there's some very significant changes that have been approved this year. Looking at page 31, in June of this year, the GASB board adopted final statements amending pension accounting and financial reporting, and Statement 25 affected the "Financial Reporting for Pension Plans," and that's been amended by number 67; and the "Accounting for Pensions by Employers" was amended by number 68. And there were some changes made from the "Exposure Drafts." There's an allocation of liabilities and also of pension expense under the new standards that apply to cost-sharing plans, like the Nebraska Public Employees Retirement System. There's some additional deferred recognition items in "Pension Expense." Measurement dates have been expanded and the reporting has been allowed to use the results for once a year for reporting for all employers, no matter what their fiscal year-end is. And the effective date has been postponed an additional year. Turning to page 32, the biggest change is the fact that for accounting they are delinking the accounting requirements from the actuarial funding requirements, so anything that they're doing for accounting purposes is unrelated really to the contribution calculations that we perform. It is required to show these amounts and it's now taking a little bit higher view of the liabilities of the plan by actually putting those liabilities on the balance sheets and running the pension expense through the income statement. So it takes a higher profile in the financial reporting for employers. The actuarially determined contribution that we prepare is to be included in required supplementary information. Now there's some new terminology, for anybody that looks at these valuation reports will notice that we use some terms in there like "actuarial accrued liability," and that's the accumulation of normal cost. It's the amount of the assets that we would expect to have accumulated as of the valuation date, and it's used for purposes of determining the past service cost of the benefits. The new GASB term is "total pension liability." When we say "unfunded actuarial accrued liability" or the "unfunded liability," GASB is going to be calling it "net pension liability," or NPL, and that's going to be used using fair value of assets instead of the actuarial smoothing methods that we use. "Normal cost" is going to be called "service cost," and "market value" is called "fair value" of assets. So the new standards and statements will require an entry on the balance sheet called this "net pension liability," and it's going to go on the balance sheet for all employers, not just single employer plan sponsors of a pension plan but also for Nebraska. For instance, the school retirement system, all the school districts and all the employers that participate will have a balance sheet item for their balance sheets, which is a proportionate share of the NPL. The discount rate is set as the expected investment rate of return that we use in the valuation, except if there are benefit payments that are expected to be run out beyond a sufficiency amount of the projected assets. We call that a crossover date, when we're projecting out contributions and investment return that don't meet all of the benefit payments. Then when those benefit payments are no longer supported by expected future assets, then any future benefit payments then are discounted back based upon a 20-year municipal bond rate, which is a lower rate, and would cause an increase in the NPL on the balance sheet for employers if there is a projected date where the money would run out. Assets are determined at fair value. Now the only difference here, the Nebraska systems are using the entry-age method; the assets, we're using a smooth method. So there would be difference there based upon the fair value of assets. And going forward, there's likely to be more volatility. As we saw from that earlier chart, there's volatility in the fair value or market value of assets. It's why we smooth the asset changes over time. But you're going to see that volatility from year to year in the measurements of the NPL that go on the balance sheet, as well as the pension expense. Now the pension expense is recognized each year and reflects recognized changes in the NPL along with contributions. So one way of looking at it is you have an NPL last year, there are changes that occur during the year; it increases with pension expense and it decreases with contributions, and it reconciles then to the amount of the NPL at the end of the year. So there's service cost that's determined under the entry-age method. You add interest on that total pension liability or actuarial accrued liability. You subtract out any expected investment return on the fair value of assets. And then over time, as any gain/loss develops or asset gain/loss or plan changes or assumption changes, those are recognized in the pension expense over...some...the asset gains and losses are recognized over a five-year basis, much like our smoothing method, and then the liability gains and losses are either immediately recognized or are recognized over the future working lifetime of the active members. Now this pension expense, people are going to look at it, especially in an income statement, and there's going to be a pension expense there and there's going to be a contribution amount there. But people shouldn't feel that the pension expense is a contribution amount because it's just a reconciliation item including all of the changes in the NPL from one year to the next. Any items of change that are not immediately recognized and they're recognized over average future working lifetime, then the amounts that are deferred will be shown on the balance sheet as deferred inflows and outflows. Turning to page 34, as I said for cost-sharing plans, the employers will share in the cost of the pensions and there will be an NPL placed on their balance sheet, which is a proportionate share of their NPL, along with pension expense and any deferred inflows and outflows. Now for special funding situations when there is a nonemployer contributing entity, for instance, like the state contributing to the school retirement system, it's required that because they are sharing in the cost of the plan, that they too would receive a proportionate share of the NPL and the pension expense for their balance sheets. So this is of particular importance to Nebraska because this is a special funding situation in the Nebraska school system, as well as, you know, the judges' system. Turning to page 35, now the final statements do provide some different ways of determining that proportionate share. They give some flexibility in making that determination, but generally it should reflect what the expected future contributions are going to be and they say that you should look at what the recent history has been for making those contributions. If the contributions have not been made at 100 percent then you can't assume that the employers are going to make 100 percent of the expected contribution going forward. So that will impact the projection of the assets for purposes of determining the discount rate. And there is a single measurement date for the plan and the employers that they can be using. And it's typically as of the end of the fiscal year of the plan. The plan, what we'll do is we'll calculate the NPL and the pension expense as of June 30 each year and then the employers can use those determinations for their fiscal year-ends that occur after that date. The effective date of GASB changes on page 36 for the retirement system, for retirement plans the changes under GASB 67 go into effect for fiscal years that begin after June 30, 2013. So for the retirement system, that's as of June 30, 2014. And then the participating employers are required to begin putting the NPL on their balance sheets and complying with these standards for their fiscal year beginning after June '14...June 15, 2014. So for FY '15 they would be complying with these new GASB standards. Now just as an example, we ran through what this would look like as of July 1, 2012, using the results of the actuarial valuation and did this for the school retirement system. So the accrued liability and the total pension liability would be the same, because we use the entry-age method. That's measured at about $9.6 billion. The assets that we're using in the valuation are the smoothed five-year assets, a little bit more than $7.3 billion; and for GASB we would be using fair value of assets, which would be a little bit lower of about $7.2 billion. So where we're using an unfunded liability of $2.25 billion, GASB, for purposes of reporting and financial statements, would be using an NPL of $2,363,000,000, so slightly greater, a slightly lower funded ratio. The normal cost and service cost is calculated the same way. What we do with calculating the normal cost is we show interest to the middle of the year because payments are made throughout the year. And for rolling the NPL from one year to the next, the service cost includes a full year of interest. Then when we calculate the contribution amount, we amortize the unfunded liability; and under GASB, GASB has an interest on the total pension liability as well as the expected earnings on investments. So there's an increase due to the interest on the liability and a decrease due to the expected earnings on the investments. So when you compare the contribution determination under the...what we do in the valuation of $230 million, the pension expense would be $222 million. But that's likely to vary a lot more over time with this volatility. The allocation of the NPL then would be based on the contributions that are made. So we're showing that on the pension actuarial calculations, that last grouping there that's the allocation of the contribution where the employers are paying $164 million and the state contributions would be $66 million, or 28.7 percent of the total contributions; the employers are making 71.3 percent of those contributions. So that allocation rate would be used in allocating the NPL and the pension expense. So all of the employers would have an allocation based upon an amount allocated to employers of $1,686,000,000, and amount for the state would be about $677 million. Here again, this goes on the balance sheet. And then the pension expense would be allocated in the same way. The amount allocated to the state would be $63.7 million, employer contributions for the pension expense would be $158.6 million, so slightly less, in the first year, anyway, until such time as volatility changes the differences between the market value and the actuarial value of assets and the recognition of any changes. And here again what we've done here is we've assumed that there would be no what we call crossover date. We have not done, you know, that analysis to determine whether or not there would be a reduction in the interest rate used to determine the NPL under these new GASB requirements. [LR452]

SENATOR NORDQUIST: So just real quick, so the liability of $1.6 billion, an individual school district would show a proportional liability on their balance sheet... [LR452]

DAVID SLISHINSKY: That's correct. [LR452]

SENATOR NORDQUIST: ...which certainly could affect their, you know, bond ratings and everything like that. [LR452]

DAVID SLISHINSKY: At least initially the feeling was that when we put these liabilities on the balance sheet and they're, you know, seeking bonds and having them rated, the feeling was that bond raters would be looking at the balance sheets and making determinations as to what the bond rating ought to be and it would affect the cost of borrowing money. [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

DAVID SLISHINSKY: And that still may be true, but some of the rating agencies are looking at doing their own measurements, so this would only be a portion of what they'd be looking at... [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

DAVID SLISHINSKY: ...and they'd be looking at their own measurements as well. [LR452]

SENATOR NORDQUIST: Sure. Okay. Thank you. [LR452]

DAVID SLISHINSKY: Okay, now...well, briefly on the projections, on the state cash balance fund we projected out the expected assets and the expected liabilities and determined expected contributions going forward. And during this time period through 2017 we're still not expecting any additional state contributions required for the cash balance plan. The same is true for the county cash balance plan. None of the additional state contributions are expected. In order for this to hold, though, during this period, the funds would still have to return 7.75 percent or some amount that's not much less than that. If there are any significant actuarial losses that occur during this time period, there's always a chance that that could necessitate an additional contribution. On the Judges Retirement System, we're projecting increases in the expected contributions as well as an increase in the additional state contributions. Now the court fees are expected to reduce from $6 per case to $5 per case in 2015, which increases the amount of the additional contribution required in 2015. We're seeing increases as well in

2013 as the losses from that last amount being recognized from 2009 is realized in 2013. State Patrol system, here again there's an increase expected in 2013 due to the asset losses being recognized in 2013, and then expecting fairly level contributions through the remainder of the five-year period. Page 43, on the school system, shows the expected increase in the additional contribution for 2013 going to $60 million; and as gains from 2010 and 2011 are recognized, there are expected reductions in 2014 and 2015. And then in 2017, when the rates change and they sunset, there's a shift in those contributions to additional state contributions. And then finally, on page 44 and 45, we ran some projections over a 30-year period of what the expected additional contributions would be under the current contribution rates that include the sunset in 2017 and rates that continue and where the rates become permanent; and we're comparing the different methodologies in amortizing that on funded either over a level-dollar amount that's currently defined in statutes or as a level percentage of pay. And you can see what the patterns are that are expected based upon those two different methods of payment. On page 44, the blue line represents the level-dollar payment amortization as currently defined in statutes. The expectation is that for 2013, with that additional loss base being experienced and recognized, that the contribution would go up, and then two more years where the gains from 2010 and 2011 are recognized, and then the spike up in 2017 as the member and employer rates drop, and then a leveling out of the contribution amounts and a gradual decline of those amounts as the percentage of pay contributions. As pay goes up, those contributions would increase and the amount of the additional contributions would decrease. Compare that with the red line, which is the level percentage of pay amortization, there's an initial drop in the amount of the required contributions under that method of amortization, and from 2013 through 2016 would actually not require an additional contribution. But with the rate sunsetting in 2017, they would go up, and there would be a continuous increase in the amount of the contributions as pay increased; and keeping the amortization level as a percentage of pay, the amount of the contributions would increase. And finally the last page, on page 45, showing the result of the employee contributions remaining at 9.78 percent and the employer contributions remaining, you don't have that spike in 2017. So it shows the amount of the additional contribution declining to zero by 2028 under the current methodology, and under the level percentage of pay continues to increase, although the amounts are less than if the rates on the employee and employer contributions were to sunset. [LR452]

SENATOR NORDQUIST: Great. Thank you. [LR452]

DAVID SLISHINSKY: So with that, I'll entertain any questions. [LR452]

SENATOR NORDQUIST: Great. So I'm looking at page 23 and 24, both on the Patrol and the school plan. We have on the school plan $344 million of expected contributions this year. And if we look at the actuarial...or the normal cost and the unfunded liability, the amortization of the unfunded liability, they're both...actually the amortization of the unfunded liability is higher now than the normal cost. What is that telling us? So first of all, for a new employee coming in, they're going to be paying their share of the contribution to contribute at a level that reaches $343 million of contributions as a percentage of their rate of pay, but their benefits essentially that they're earning is only on the level of about $194 million? [LR452]

DAVID SLISHINSKY: That's correct. What that says is that now more than 50 percent of the total is to pay for... [LR452]

SENATOR NORDQUIST: Liabilities that have already been... [LR452]

DAVID SLISHINSKY: ...liabilities that have already...based on service to date. [LR452]

SENATOR NORDQUIST: Uh-huh. Okay. So if we're looking at...and maybe this is something we can do, too, with the model that we've constructed. What...if we were to look at any kind of benefit changes to either current or future employees, and obviously there are court precedent so we have to look at it changing for current, are there any changes in particular that jump out as having a big impact? I mean the Rule of 85, vesting, how many years you calculate your final salary over...I mean which of those have the most impact actuarially? [LR452]

DAVID SLISHINSKY: Well, first of all, when you...and a lot of states have created new tiers of benefits. [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

DAVID SLISHINSKY: If you have a constitutional protection for benefit rights for current members and if you can't change those, then some states, what they've done is they've gone to a new tier of benefits. When you go to a new tier of benefits, you know, some of the more powerful items would be a reduction in the formula, a reduction in the eligibility for special early retirement or even an increase in the normal retirement age. But changes under a new tier take a long time to take effect,... [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

DAVID SLISHINSKY: ...so you get small but increasing savings over time with a lower value of benefit. [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

DAVID SLISHINSKY: You get...you could get a better impact or a greater impact for any changes to current members, but those are usually limited based upon state law. [LR452]

SENATOR NORDQUIST: Sure. Sure. On page 45, sorry to make you flip around again, so looking at if we would remove the sunset and move to a level percent of pay amortization, looking at the red line, how that grows up to 2036, would that be a structure where you then could incorporate changes to new hires and essentially begin to bend that curve down as new hires come into the system with a second tier of...a lower tier of benefits? [LR452]

DAVID SLISHINSKY: Yeah. If we go back to the results on page 23, when states have used a different tier of benefits, if you use a lower multiplier in their benefit, if you use a higher normal retirement age or special early retirement age, that decreases the normal cost amount. [LR452]

SENATOR NORDQUIST: Uh-huh. [LR452]

DAVID SLISHINSKY: If the amount of the contribution is kept the same then there's additional monies that are collected over time that helps to pay down the unfunded liability. [LR452]

SENATOR NORDQUIST: Uh-huh. Okay. And then one last question for me and I'll see if other people have questions. On the change of level dollar versus percent of pay, obviously percent of pay gives us breathing room now but might make it...I assume that we'll end up paying more in the long run. [LR452]

DAVID SLISHINSKY: Yeah, I think, yes, and... [LR452]

SENATOR NORDQUIST: Is there a way to...do you have...is there a way for you to give us a calculation over a 30-year period for, like the school plan, what the aggregate difference would be over that 30-year period of choosing the percent of pay versus the level payment? [LR452]

DAVID SLISHINSKY: I could give you a dollar amount... [LR452]

SENATOR NORDQUIST: Yeah, okay. [LR452]

DAVID SLISHINSKY: ...that's calculated based on the... [LR452]

SENATOR NORDQUIST: Okay. [LR452]

DAVID SLISHINSKY: But the way I like to read this chart, whether it's the chart on page 44 or the chart on page 45, when there's a difference between the blue line and the red line, that's the amount, this area between those two lines, between 2012 and the point in time when they cross at 2023, that's the additional amount that you would be paying now. And then after 2023, when it reverses, that's how much more you'd be paying in the future. [LR452]

SENATOR NORDQUIST: Uh-huh. Sure. Sure. So it's the difference of those. [LR452]

DAVID SLISHINSKY: So it becomes, as I say for pension funding, it's a pay me now or pay me more later situation. [LR452]

SENATOR NORDQUIST: Uh-huh. Okay. Any other questions from the committee? None? Seeing none, all right, thank you. [LR452]

DAVID SLISHINSKY: All right. Thank you. [LR452]

SENATOR NORDQUIST: Any other testimony regarding the report we just received? None? All right. Oh, we do. Okay, great. Welcome. [LR452]

ANN POST: I'm neutral. I wanted to make sure somebody else could go first. [LR452]

SENATOR NORDQUIST: Sure. Welcome. [LR452]

ANN POST: Good morning. My name is Ann Post. I'm here on behalf of the Lincoln

Independent Business Association. And I'm in front of you today because, as you may be aware, LIBA has been monitoring city and state budgets for 32 years. And I'm just here today to tell you that we've been looking at pension plans in the state of Nebraska and we're worried, worried about Nebraska, its budget, and how the necessary additional contributions that are going to be required in these pension plans are going to affect Nebraska's budget in the future. We're aware that the Legislature has been studying and gathering information on alternative retirement plans, and LIBA would simply like to encourage the Legislature to continue to do that. Simply stated, the current level of pension debt of required contributions we see as an unsustainable burden on the Nebraska taxpayers and that they can't afford to pay. [LR452]

SENATOR NORDQUIST: Okay. All right. Thank you, Ann. Any questions, comments from the committee? [LR452]

ANN POST: Thanks. [LR452]

SENATOR NORDQUIST: Thank you for being here. Any other testimony? Seeing none, that will conclude our morning hearing and we will be back here at 1:00 for the hearing on LR518. Thank you all. [LR452]

BREAK

SENATOR NORDQUIST: (Recorder malfunction)...District 7, which covers downtown and south Omaha. We're here to hear LR518 introduced by Senator Mello. Our committee staff to my far right is Laurie Vollertsen; to my left, Kate Allen. Our page today is Evan. And we have Senator Lavon Heidemann from the 1st District; and Senator Mello from the 5th District as committee members; and I think Senator Karpisek also may be joining us. With that, please silence your cell phones. State and spell your name when you testify. There are testifier sheets in the back to fill out and provide those to the committee clerk. And there is Senator Karpisek from the 32nd Legislative District.

With that, I'll turn it over to Senator Mello to open on his LR. [LR518]

SENATOR MELLO: Good afternoon, Chairman Nordquist, members of the Nebraska Retirement Systems Committee. My name is Heath Mello, H-e-a-t-h M-e-l-l-o, and I represent the 5th Legislative District in south Omaha. First off, please pardon my voice. I'm currently battling a pretty nasty cold and sinus infection now, so if I need to be a little louder just let me know. LR518 is an interim study to examine issues surrounding the investment of state retirement funds with a particular emphasis on whether the Legislature should amend current statutes to allow the Nebraska Investment Council to invest or reinvest assets of Nebraska's Retirement Systems in economic development ventures within the state. Before we begin, I would like to thank the committee legal counsel, Kate Allen, as well as Jeanne Glenn and Kathy Tenopir from the Legislative Fiscal Office for putting together the materials that were distributed to the committee and for assisting my office with preparations for today's hearing. Within the current statutes governing the Nebraska Investment Council, Nebraska Revised Statute Section 72-1239.01 provides that, "No assets of the retirement systems or the Nebraska educational savings plan trust shall be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives." This policy against what are commonly referred to as economically targeted investments or ETIs, which has been on the books since 1996, places Nebraska clearly in the minority of states. Just 10 states currently discourage or prohibit the use of pension or other public assets for ETIs, while 27 states allow, encourage, or mandate the use of such funds for the same purposes. I do not come in front of the committee today or today's hearing with a preconceived notion of whether the current statutory ban is the correct state policy. Rather, my hope is that today's hearing will give the committee a chance to explore the history behind the statutory language, examine any potential costs or benefits from changing this statute, as well as learn more about what the state is currently doing through the Nebraska Investment Council. I've asked committee legal counsel, Kate Allen, to give a brief overview of the legislative history of the bill that created the current statutory language. And we've also invited the state investment officer to join us this afternoon as well. Thank you for your time, and I'd be happy to answer any questions you may have. [LR518]

SENATOR NORDQUIST: Great. Thank you, Senator Mello. Any questions? Senator Heidemann. [LR518]

SENATOR HEIDEMANN: Who invests the Cash Reserve, money for the Cash Reserve? [LR518]

SENATOR MELLO: The Nebraska Investment Council. [LR518]

SENATOR HEIDEMANN: So why do you pick on the retirement side of it? Why don't you just say let's invest the money from the Cash Reserve and...? [LR518]

SENATOR MELLO: I think...once again, I think we're going to learn a little bit more I think about...from the Investment Council in regards to what they're currently doing. No doubt they'll walk through a little bit of what they're doing in regards to I think some of the information we received this morning in regards to their current investment portfolio. We looked at it generally just because the language was very specific in the retirement systems in regards to the state retirement or educational savings plans. So that's the reason we wanted to look at why that language was there and explore all...utimately I think Director States is going to be able to kind of walk through what they're currently doing at the NIC as well as potential pitfalls as well as opportunities in regards to looking at Cash Reserve funding or other cash funds that get invested by the NIC. [LR518]

SENATOR HEIDEMANN: Thank you. [LR518]

SENATOR NORDQUIST: All right. Any other questions from the committee? Seeing none, thank you, Senator. [LR518]

SENATOR MELLO: Thank you. [LR518]

SENATOR NORDQUIST: I think Kate Allen will be our next testifier. Thank you, Kate. Go ahead. [LR518]

KATE ALLEN: (Exhibit 1) Good afternoon. I'm Kate Allen, legal counsel for the committee, that's K-a-t-e A-l-l-e-n. And Senator Mello asked me to review the legislative history on this specific provision, and it goes back to 1996. It actually goes back a little bit earlier. In the early 1990s, the Retirement Committee conducted a two-year comprehensive review of the retirement systems. One of the issues they examined was the organizational structures of the Public Employees Retirement Board and the Nebraska Investment Council and their fiduciary duties. In 1966, LB847 was introduced by then-Chairman Wickersham at the request of the Governor, it was Governor Nelson, to amend the organizational structure of staff under the Public Employees Retirement Board and the Nebraska Investment Council. As originally introduced, it proposed in part that all of the staff under the PERB and the Investment Council would become employees under a newly created Retirement and Investment Division in the Department of Administrative Services. In Senator Wickersham's introduction, he said that LB847 was designed to begin the conversation on how we can find a proper mix between general principles of accountability and independence with regard to these two boards, an independence to assure that decisions made are free from political influence and are made in the best interests of the system. The issue of targeted investments arose during questioning by Retirement Committee members about trying to remove political influence from investment decisions. Senator Wickersham responded that he thought allowing targeted investments would be unwise unless they provided an appropriate return and an appropriate rate of risk. When the Governor's representative testified, he specifically referenced committee questions about targeted investments and stated that the administration would be willing to accept some type of prohibitive language limiting the use of retirement funds for targeted investments. The bill was amended in committee; and in floor testimony, Senator Wickersham referenced the two-year comprehensive study of the retirement systems, examining a number of issues including structure and governance, and he summarized the committee amendments, referencing the provision that would restrict the kinds of investments that could be undertaken by the systems. He described the Internal Revenue Code exclusive benefit rule which provides that assets must be invested solely for the purpose of providing benefits to the beneficiaries of the retirement system. He stated, in some cases in other parts of the nation, there have been folks who wanted to take retirement funds and invest those for social and economic purposes. That is not an appropriate purpose for retirement funds. Retirement funds are supposed to be invested to provide future benefits for the workers who are now making contributions and the employers who are making contributions. There were no further questions or discussion on that provision on the floor, and it was passed as it came out of committee. So that is the history of the actual language. In addition, Senator Mello asked me to...you have before you a summary of states that have policies regarding use of pension and other public assets for economically targeted investments, and this is taken from a Rockefeller Foundation study where they surveyed all the states and came up with this chart. This was from February 2012. And according to the foundation's research, approximately 27 states allow, encourage, or mandate economically targeted investments. However, if you look at all of those provisions, all but three of those states include some sort of qualifier or limitation on economically targeted investments that require sound investment policy, prudent investor, investment standards seeking equivalent market returns so they are not without some sort of limitation on what the board must consider when they are targeting investments. Do you have any questions? [LR518]

SENATOR NORDQUIST: Thank you, Kate. Any questions from the committee? Seeing none, thank you. Next testifier. Welcome, Jeff. [LR518]

JEFF STATES: (Exhibit 2) Senator Nordquist, members of the committee, my name is Jeff States, that's J-e-f-f S-t-a-t-e-s. I'm the state investment officer for the Nebraska

Investment Council. I believe you have a copy of some prepared remarks or material that I presented for you. I'll just flip through this quickly and then we can talk more about the issue. But as the Senator highlighted, this LR518 directly talked about issues surrounding investment of state funds; and I'll provide you some brief background with respect to the total context of state fund investment, and then specifically address the issues related more pointedly to the retirement funds. But on the second page, the Nebraska statutes which govern the investment of funds are basically the Nebraska State Funds Act, Section 72-1237 through 1260, and the Nebraska Capital Expansion Act, Sections 72-1261 through 1269. And then most of the other statutes that create cash funds and other sources of revenue just reference these sections as requiring them to be invested in accordance with these statutes, which places them under control of the council. Our constitution always governs but has very little to say about investments. And then federal statutes, and I think having listened in this morning you heard a little bit from the Groom folks about the history particularly with the IRS with respect to the requirements that they set in order to make sure that retirement plans maintain their qualification as a qualified benefit plan. All plans administered today by the council in the fourth slide are represented on this page. Fifty-seven percent of these are retirement plan related. But as important from the council's standpoint, with the exception of the funds that would be in the operating investment pool, which are cash fund monies, each of these has a statute that provides some specific identified use for them. So not that that use couldn't be modified, but, you know, they're earmarked for veterans, they're earmarked for cultural uses or a variety of other purposes. I would also tell you this includes the College Savings Plan. My remarks won't address that too much, and the reason I've sort of excluded that, it falls in the statute that we're looking at; but as you know, the College Savings Plan, the council's responsibility is to ensure we provide a range of investment options for the members. But the participants in that plan self-elect, and those assets never really are funds of the state. The state created the program to allow folks to take advantage of the federal 529 program, which provides tax advantages. They decide based on the options we give them how to allocate those monies, but the council in no sense actually invests the funds that are in the College

Savings Plan. Next page. All the assets today as of the end of September that are available and under the oversight of the council totalled about $17.5 billion. And again, the retirement assets are highlighted at the beginning, totally almost today, almost $10 billion when you add up all of it. It fluctuates obviously with the market. As we turn the issue towards I think the relevant statutes with respect to the council--and I've highlighted here 72-1239.01--constantly sets as a standard the requirement that the council conduct its activities as a fiduciary. It does it as it relates in paragraph (1) under item (b) for the retirement funds, which are the Sections 84-1503 and the others highlighted. And specifically...and that says, you know, "trust solely in the interest of the members and beneficiaries of the retirement systems or the interests of the participants and beneficiaries of the Nebraska educational savings trust." But I think the pertinent area are the retirement assets. The second portion of that also relates to the broader general question of the other assets that the council invests. And again, it says, "The appointed members of the...Council shall have the responsibility for the investment management of assets of state funds," and again holds them to the standard of conduct to act as a fiduciary. And then the fiduciary standard itself is set out a little more clearly in section (3), which is that "the council shall act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person act in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims by diversifying the investments of the assets of the retirement systems, the Nebraska educational savings plan trust, and state funds so as to minimize risk of large losses, unless in light of such circumstances as prudent not to do so." I would cite just as a little bit of history, and Kate did a good job and I think she and Kathy helped provide me a little of the background also, knowing where the language in the statute came from in '96. But in acknowledgement of that, I found looking at statutes there are two places where in law the Legislature has chosen to give some direction to the council to invest funds from monies available to it more directly instate. One of those is an older statute, which was 72-1246.01 which was related to our authority to invest in student loans. That was from 1971. And in that early period in the '70s as student loans were originated, there was no securitization market at that time, and so you didn't have Sallie Mae, you didn't have Nelnet, and other groups. And so I think the banks in the state as they were assisting with that had loans that might be available to purchase, and if they had the quality characteristics and were guaranteed, the council was generally authorized to purchase them. I have no history beyond that to know whether they were actually done, but I think the need for that authority even though the statute still resides on the books went away because the securitization market developed; and as you know today, the federal government basically originates in a new student lending. The other statute is the 72-1261.69 which is the Capital Expansion Act, which really provides authority for deposits to be made in Nebraska banks up to a million dollars, and provides for a rate to be done. Basically those funds that are invested though actually come out of the operating investment pool resources. So that really is probably the pot of money that's, you know, subject entirely to legislative and to statutory control, and other than being earmarked for operating expenses, doesn't have a dedicated use in the same manner that the various cash funds do that are set up specifically. That wouldn't trivialize the fact that each agency that has a cash fund doesn't rely on those cash funds to fund their ability. But to that extent, we have, and the Treasurer does, place deposits. Those deposits are required to be collateralized to the extent that they're not insured by the federal government so they are fully protected. Today we have something between $30 million and $35 million which is still outstanding on that. Because of the current liquidity in the marketplace, banks basically have been returning that money more than taking the deposits at this time. Turning to the next page, and this will jump into more pertinent information, and I think as Senator Mello referenced, what we're talking about are what are generically called ETIs or economically targeted investments. The use of this term kind of isn't specific with respect to being able to categorize it exactly with respect to what might be done, but it does constitute basically a whole host of things in a variety of states with respect to giving some preference or placing assets based on a geographic distinction or a sector. What's unique to these is and it's highlighted there is that generally this establishes then sort of a dual investment objective. And as a fiduciary, that primary objective continues to be to provide a competitive risk-adjusted rate of return; and secondarily, if that objective is met, then to attempt to provide some collateral benefits either through targeted geographic areas, groups, or sectors. Loosely you have identified there--and this is information provided by Hewitt EnnisKnupp that's our consultant--the majority of the programs that are authorized in other states tend to either be for private equity, typically investments in local, state, or venture capital; real estate housing; real estate other, which would be more or less direct investment in properties; and then small business loans. I would say I think as it relates to affordable housing, Nebraska has other means and methods to provide for that; and as far as I know, we've never had any direct involvement from the Investment Council in that. Nebraska...NIFA does provide, you know, low income or a tax advantage to (inaudible) lending to try to encourage home ownership, and I believe there are probably other affordable housing statutes. Private equity and real estate, the council does currently invest in, and I'll explain that in just a moment. It's just it's not targeted on a specific manner to Nebraska-related programs. And then small business loans. Generally these, where there have been experience, are SBA loans. To the extent SBA loans in general are securitized, they are an eligible investment for the operating investment pool. They would be eligible investments for our externally managed fixed income portfolios. We do own SBA loans from time to time, but they're not again SBA loans that are geographically specific to Nebraska. In the TDOA program would be something like what you'd consider to be a linked certificate of deposit. The council itself under its authority generally invests in a diversified portfolio of securities, primarily using qualified external investment managers, with the exception of what we do with the operating investment pool and some of the specific earmarked cash funds that are dedicated sources where we may manage some of the fixed income in-house, but we don't do any of the equity or private equity investing. As I said, the asset allocation includes public equity, private equity, real estate, and fixed income as the primary sources. And then just on the next page are highlighted what those are so that you could quantify the pools, and that table provides a little bit of background on investment returns. The next page has some information that I've provided you from our investment advisor with respect to the exposure that we specifically have and can quantify in the private equity program related to Nebraska. In the public markets we invest and would own almost any and all publicly traded corporations. And so to the extent that a corporation like ConAgra publicly trades stocks and we'll own it, a number of other corporations we would own them at our portfolios because we believe them to be good investments. They'll either be in index funds that we own or sometimes in our specific manager portfolios, but again those are discretionary decisions by the outside managers the council hires to make the best investment decisions. In the private equity arena, the council makes investments in private equity through, again, external managers in funds. Those funds are managed by groups of people that are general partners that have expertise in doing this kind of investing. The allocation, and this was to give you a little geographic background on what's there, Nebraska specific is that smaller piece which is about .9 percent; other Midwest, which is also small. You can see 52.1 percent of the assets generally are in the U.S.; and the either unknown or non-U.S. are about 14 percent of the assets. Actually I misrepresented. The 32.7 would be the other Midwest, so that there is significant Midwest exposure but not necessarily Nebraska. The second page provides the dollars that are associated with that which makes it a little clearer. To date, we have invested from called capital about $270.6 million; $324.7 million by market value; roughly $45 million in the Midwest; and a total...well, and $1.6 million that can be specifically traced to Nebraska investments. We also invest in real estate. I could not target the specifics of real estate in Nebraska, and so I'm not aware that we own in any of the funds that we invest in. We don't do direct ownership of real estate, so we don't buy properties in the name of the state of Nebraska. But we invest in portfolios of commercial real estate in these property types. Geographically, because they're the strongest commercial markets tend to be on the West and East Coast, but the Midwest itself constitutes about 10.6 percent of those assets. I do know sporadically there have been things that would be institutional grade that could be owned and have been, by funds that we might invest in, but I would not say we have. In the Omaha area and occasionally things like the Cornhusker Hotel which was involved in a fund-type investment that would be, because of its quality at least at the time that was done, would have been an asset that we could have had some exposure to. And so my point being that I think the current statute as provided sets no limitation even though it says that our primary objective should be as a fiduciary and never to be economic or social, that the broad authority allows the council to make investments in projects that basically meet the institutional quality for investment return and the investment characteristics that they feel are proper to be, you know, I mean sound investments invested, though primarily and solely really for the benefit of the beneficiaries of the assets. The next page is just a peer survey from EnnisKnupp that looks at some comments with respect to the time spent by areas that do this; and I think one of the issues is that if you're doing it, what's involved. They contacted some 126 various entities. I think they only specifically indicated they had about 25 or 26 plans that directly responded, but then they also made calls. And the responses that they found are these, the time spent on this. About 25 percent said, about the same amount of time they were spending otherwise; 24 percent, more time; 13 percent, much more time; and then you can see there, less time, and much less time. Not a clear indication, but it seemed that if you look at the bottom that when asked how much time plans spent on overseeing their ETIs that whether they were spending a lot of time or not in many cases depended on whether they were using internal staff or they had contracted it with a gatekeeper. And if they're hiring a gatekeeper, that's an expense; but they didn't quantify that as being taking their time. And most systems do describe their plans as requiring at least the same due diligence and monitoring that they would impose on any traditional investment. The response, also a question, you know, as it relates to investment return, because we've said in order to make an investment, we believe it has to be of a similar quality to other investments that would be made and provide a similar risk-adjusted return. These were kind of the responses. We found it hard to find direct specific information. The quality of the information, each state kind of generally reports and blends it into other material; but were that none of them specifically said that they were ahead of the benchmark; about 60 percent said their returns were benchmark-like; and 40 percent based on this survey indicated that their returns might have lagged their benchmarks a little bit. The benchmarks, and this just summarizes the kind of things that might be used depending on the nature of the investment. If you were doing bond purchases, you'd want similar rated bonds of a maturity and characteristics, so you would price them to the market so that they would be similar, and this would be more direct-type lending. SBA loans, you know, they're priced off of treasuries. They're government guaranteed. Probably have the least risk for you, but I'm not sure that there's a need specifically by the state of Nebraska to be purchasing SBA loans to create a market for that. Private placements, we've talked about, and that really is going to be related to the specific characteristics; CD programs, and our statute provides and we have rules that provide how we do that; and then venture capital. There are some measures developed by independent third-party sources for establishing benchmarks for that. I provided...the next page which comes out of that same survey, reasons for not having an ETI program. This may be self-serving. But you can see that of the various jurisdictions, some states have fund policies against them; 4 percent have state statutes or laws against them; 30 percent probably are in the pool that we would find ourselves in today, which is that they find that it's inconsistent with their fiduciary responsibilities to the plan participants. We would also argue that for the time and effort that it would constitute for us to do this, that this is a limited opportunity set. It certainly can come with a high-risk profile and not necessarily with a return that we would feel comfortable would be risk compensated. The last page is some characteristics of what EnnisKnupp has indicated would be characteristics for best practices plan. First and foremost is the fiduciary duty. Secondly, you would have investment policies and guidelines that are approved by the council in this case. I think prudent and particularly important for this if you look at the costs are the diligence and documentation required. In this case, if we hire managers, we would have to follow those rules. If we're doing it with internal staff, we have to make sure we're resourced with folks who really have the characteristics and the competence to underwrite the risks related to these direct investments, and they can be significant. There are issues, and some of this relates back to probably the original source for this, potential conflicts of interest as you start to respond to direct concerns both for the people who are interested as well as managers, if you hire managers that are in-state and trying to direct investments. And I'll just maybe finish there except to say that for us to have a program if the state was interested, one, I think we would encourage the state to find a pool of assets other than the retirement fund assets because we...you heard this morning, I mean, and you have heard regularly the fact that the state has an unfunded liability. And I think the council as well as the retirement system wants to focus on making sure that we do the best job we can to, over time, achieve a return that's going to help fund that obligation. Anything like this would probably be marginal, but it would be a distraction and would require a dedication of staff resources. I think quite frankly I would also say, as most of you know I've been here three years, I've had little specific contact anyway from the investment community, and that's not to say it's not there, requesting us to provide investment funds for specific projects in Nebraska. I think many folks view other sources available to it. Or when you find economically targeted investments, if they're bigger scale, many times what people want is either a reduced cost in their funding, which we can't do if we're getting a comparable return to other investments. It's also difficult...or what they want are covenant-light types of things if you're trying to do direct lending, or they're really looking in the venture capital area more for an angel investor that really has money they're willing to put at a higher level of risk than we think we could do. And last would be that we either would have to hire an outside advisor to work with us. To really do a thorough due diligence of any individual project would require external legal counsel to help make sure the legal documentation was proper. And if we did it internally, we'd really have to have staff that was dedicated to that. And I think with that, I'd close and respond to any questions. [LR518]

SENATOR NORDQUIST: Thank you, Jeff. Questions from the committee? Senator Mello. [LR518]

SENATOR MELLO: Thank you, Jeff, for walking us through this as well as for the due diligence you did in preparing a lot of this research to provide the committee. Could you--and we spoke prior to today's hearing--could you give a little bit more background on your experience in New Mexico with a state that did somewhat similar ETIs in-state, that did it in-house? I know you just walked us through the pros and cons of doing an in-house system, but from your professional experience of doing this, can you walk us through that? [LR518]

JEFF STATES: Sure. In my prior experience when I...in the late 1980s I did work for the New Mexico permanent fund for the state of investment office. I would say first the funds that they were investing were not retirement fund assets. The permanent funds were severance tax monies. It was legislatively created and then constitutionally approved, but fund that was subject from an investment and an expenditure standpoint only to legislative control. And so they were monies available for the legislature to provide direction on how to invest. My role at the investment council was to provide oversight to what we considered to be the New Mexico direct investment programs. A significant portion of what we did was place deposits actually of funds in state banking institutions. As you may know, in the mid- to late-eighties because of some financial crisis during that period, savings and loans were struggling and banks needed assistance. The state of New Mexico in and of itself provided a lot of money as deposits to help the banks have depository funds to lend. Those were all collateralized deposits and they took time and effort. We also, during that period, purchased SBA loans from the banks that they originated. I am aware that they don't do that program any longer. And I think again it may be the nature of the fact that as we moved into the nineties, securitization came along and so the ability. There was no need for a secondary party. But we were buying the guaranteed portions of the SBA loans with funds from the severance tax permanent fund. The bank would service them and retain the unguaranteed portion, but because of the characteristics it worked for each of the entities. And then separate from that we had a couple programs that were somewhat more targeted, one of them being a loan participation program. We did do, but over a two- or three-year-period, I think what it ultimately ended up being two or three loans that were to help businesses locating in-state. One was a meat-packing plant that we worked on. The characteristic of that as well as a direct loan...well, a loan that we did for...it actually ended up being a motel in a small community, were things that we did partnering with other groups. And so we kind of laid off some of the burden by working with the banking community in New Mexico who helped us. Basically our role in these in many cases was to agree to participate in the loan because it was a loan at the time that was maybe a little bit larger than the individual institution could write. And in the late eighties, at least in New Mexico, the upstream correspondent relationships had kind of evaporated for some of these banks. So the Texas banks they had gone to had kind of gone bust or weren't available at the time because of problems in the oil and gas industry. It took a lot of time and effort but we did do some of this. They also had created a venture capital program which I did not work directly with but was associated that was targeted towards providing private equity funding in the state. They found that the way to do that--and I think there's some reference in this material--was to develop a more geographic program; and then they hired a third party to due diligence each of the individual investments because they found that the pool of opportunity in the state was really relatively shallow from a creditworthy standpoint. So they would take ideas and then they would funnel them off; and if they met the characteristics, then they might come back and put some funding. But each of those required both staff time and in most cases required legal assistance and outside advisors. I had a staff of two other people, so there were three of us just doing the SBA loans, the deposits, and looking at the direct lending-type activities. [LR518]

SENATOR MELLO: So it would be safe to say if this was something that we would consider, the Legislature would consider moving forward, and the investment council obviously taking into consideration I think what your opinion was as well as Senator Heidemann mentioned earlier about looking at nonretirement, noneducational savings plan funds, it would probably require your office a cash appropriation of enough to cover at least two to three staff to even just contemplate looking at your potential investment opportunities. [LR518]

JEFF STATES: It would. And I would say, you know, additional resources from an advisor that would probably be--could similar to what we're paying for real estate or private equity today--be another couple of hundred thousand dollars for each relationship, depending on the nature of what it was. I guess I would also close by saying what I am not sure of is what the in-state demand is for our involvement in this program because that's not where I'm seeing the economic development issues occur. That may not be because they're there maybe. But I see things come through the NIFA where I sit that are more trying to encourage local communities to do things, and they're interested in the tax benefits in many cases, if they can get them. And then you look at the bigger things like the Innovation Campus and it's...you know, it's ConAgra and folks that can step in there, but it's really finding tenants that want to do research and development and need resources. Those are more development-oriented projects and/or commercial, but again they're getting done. And so I would say part of the question involves an issue with maybe the state's Department of Economic Development if we need investment capital in this state to be directly, you know, placed within the state in that manner, other than the general way we're currently doing it. [LR518]

SENATOR MELLO: A quick question. You said a couple entities. You've been contacted only a couple of times. What were the...do you know those...do you remember the industries it was...any particular industry, in general, energy-related or manufacturing-related, anything potentially that someone who has reached out to the Investment Council to seek potential investment funds from you? [LR518]

JEFF STATES: In the time period I've been there the only direct contact I've had were some folks interested in a real estate investment fund, and it's been commercial real estate rather than industrial or... [LR518]

SENATOR MELLO: Okay. [LR518]

SENATOR NORDQUIST: Great. Thank you, Jeff. Senator Heidemann. [LR518]

SENATOR HEIDEMANN: Where did New Mexico get their severance tax? What did they tax? [LR518]

JEFF STATES: It was oil and gas and uranium monies. [LR518]

SENATOR HEIDEMANN: How big was their permanent fund? [LR518]

JEFF STATES: Oh, a billion and a half, two billion dollars, something like...I mean, their monies are even bigger today. But in the period that I was there, you know, uranium went through a period where the price per pound of ore went from $40 to almost $100, actually an ounce. I mean, it got to be quite pricey, and then the industry kind of crashed; but it threw off a lot of money. But the state also generated and still is generating a lot of oil and gas money, and that was the primary. It was from leases from...well, it was rental payments and collected taxes off of those. [LR518]

SENATOR HEIDEMANN: What was their purpose of the permanent fund? What were they going to do with that? [LR518]

JEFF STATES: The purpose of setting it up was basically a belief that we were using depletable resources and that the state wanted to establish a fund that would just generate revenue. The severance tax permanent fund was to generate a source of income that was available to the legislature to use for general government. [LR518]

SENATOR HEIDEMANN: Down the road. [LR518]

JEFF STATES: Yeah. [LR518]

SENATOR HEIDEMANN: Thank you. [LR518]

SENATOR NORDQUIST: Thank you. Any other questions? Seeing none, thank you. [LR518]

JEFF STATES: You're welcome. [LR518]

SENATOR NORDQUIST: Any additional testifiers? Seeing none, that will conclude our hearing, unless Senator Mello would like to close. That will conclude the hearing on LR518. Thank you. [LR518]