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Nebraska Retirement Systems Committee
December 21, 2015

[LR243]

The Committee on Nebraska Retirement Systems met at 8:30 a.m. on Tuesday, December 21, 2015, in Room 1525 of the State Capitol, Lincoln, Nebraska, for the purpose of conducting a public hearing on LR243. Senators present: Al Davis, Vice Chairperson; Mike Groene; Rick Kolowski; Mark Kolterman; Brett Lindstrom; and Heath Mello. Senators absent: None.

SENATOR DAVIS: I think we'll get started. We don't have a whole lot of time and we've got a lot of material to go over. Want to welcome everybody here today. And I'm going to let the senators introduce themselves starting here with Senator Groene.

SENATOR GROENE: Senator Groene, District 42, Lincoln County.

SENATOR KOLOWSKI: Rick Kolowski, District 31, southwest Omaha.

SENATOR LINDSTROM: Brett Lindstrom, District 18, northwest Omaha.

SENATOR DAVIS: I'm Senator Al Davis from District 43, north-central and western Nebraska.

KATE ALLEN: Kate Allen, legal counsel for the committee.

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

SENATOR KOLTERMAN: Mark Kolterman, District 24, Seward, York, and Polk Counties.

SENATOR DAVIS: So before we begin I want to thank Phyllis and her staff and the PERB members, the actuaries, Michael Walden-Newman, the State Investment Officer, and the Nebraska Investment Council members and staff for all their work on behalf of the retirement planning members. We really appreciate the difficulties and challenges that you work with every day and we want to work with you collaboratively on this and other retirement issues and investment issues. I also want to recognize Catherine Larsen, the committee clerk over here, and our page, Brandon Metzler. So the most recent action that precipitated this hearing on the

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assumed rate was a November 30, 2015, letter to PERB signed by each member of this committee seeking board action so that the December 2015 meeting in which they might lower the return, the assumed rate, to 7.75. This is the assumed rate for the plans recommended by the actuary in the 2012 experience study. So, Phyllis, are you going to be the first testifier? So we'll take invited testimony initially and then we'll move on. I want to make sure we have time to hear from Michael Walden-Newman. [LR243]

PHYLLIS CHAMBERS: (Exhibits 1 and 2) Well, good morning, Chairman Davis and Retirement Committee members. For the record, I'm Phyllis Chambers, P-h-y-l-l-i-s C-h-a-m-b-e-r-s, and I'm the director of the Nebraska Public Employees Retirement Systems. [LR243]

SENATOR DAVIS: Phyllis, before you start, can I ask you... [LR243]

PHYLLIS CHAMBERS: Yes. [LR243]

SENATOR DAVIS: You know, we sent the letter to you on November 30. Would you focus on the response of the PERB committee to that question? [LR243]

PHYLLIS CHAMBERS: Certainly, certainly. [LR243]

SENATOR DAVIS: Thank you. [LR243]

PHYLLIS CHAMBERS: Okay. And I did want to say that Denis Blank, our board chairman, sends his regrets. He is unable to be here today because he has...his son has a serious illness and he takes him to dialysis on Monday, Wednesdays, and Friday mornings. I will be testifying today on behalf of the PERB, and I wanted to make sure the record reflected that we have a number of PERB members here today. Richard Wassinger, Elaine Stuhr, Janis Elliott, Ron Ecklund, Dennis Leonard, and Kelli Ackerman are present at the hearing. And we have Pat Beckham and Dr. Brent Banister, our actuaries, are also here testifying, as well as Orron Hill, our legal counsel. The board received your letter, dated November 30, requesting that the PERB lower the investment return assumption from 8 percent to 7.75 (percent) at the next PERB meeting. The request came as a complete surprise. In fact, Ms. Beckham, our actuary, presented the school,

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judges, and Patrol valuation reports to the Retirement Committee on November 18; and the committee did not ask any questions about the assumed rate at the hearing. The funding levels of the defined benefit plans continue to improve and are on track to be fully funded. Nothing has been communicated to the PERB by the committee since 2012 that there was any concern about the assumed rate. The board subsequently received Senator Davis' e-mail on Monday, December 14, notifying us of the hearing today prior to our board hearing. Another e-mail was sent to the PERB last Friday, December 18, with a list of questions. The board has not had an opportunity to meet publicly to discuss your request due to the short notice that you have given them. The PERB meeting is at 10:00 a.m. today and you are all invited to attend. The PERB has not had enough time to properly research all of your questions, but I will do my best. The November 30, 2015, letter referenced the 2012 actuarial experience study. That study was based on 2011 data by our previous actuary, Buck Consultants, and incorporated the severe economic crisis of 2008-2009. When the actuary presented the 2012 study to the PERB on August 20, he recommended that we lower the assumed rate to 7.75 (percent). Prior to the meeting, the actuary told us that we did not need to wait until the following meeting to approve the change. He said that that's the way they'd always done it before and that he wanted to begin preparing the defined benefit plan valuations for November as soon as possible because he would need time to make the change. We had not changed the assumed rate since 1997. The board voted to approve the changes to both the economic and demographic assumptions recommended by the actuary. The board did not release the report prior to the PERB meeting. The practice at that time was not to release reports because all of our reports are in draft form and subject to revision until presented and officially approved by the board. Not all board members had the opportunity to review the reports because the previous actuary did not always have them to us until the last minute. The PERB was immediately criticized by the administration for changing the assumed rate. The board knew there would be an economic impact to the budget. We didn't know how much. We...due to the financial crisis, the funding levels of the plan had dropped and the additional required contributions were in the millions of dollars. By lowering the assumed rate a quarter of a percent, the required contributions needed for all the plans was approximately \$89 million in 2013 and '14 and \$107 million in 2014, '15, with more contributions in succeeding years. And we didn't know. At that time we didn't really have the 30-year projections, models. We were just going by two- and five-year projections. So the school plan members did come to us and communicated to our board members that...their concerns about lowering the assumed rate since

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they had had one contribution increase the year before and they were concerned they'd have another. Because lowering the assumed rate would significantly affect the state budgets, we consulted with the actuary and we discussed going back to 8 percent at the next meeting. There were so many different things going on at that time. We discussed waiting a year to see what would happen to the market. The actuary said it would not make that much difference over the long term if we waited a year to change the assumed rate. We were working with the Retirement Committee on modeling some important benefit changes to the plan and we thought it would be helpful to wait and see what those changes would be on the funding levels. This would give us a year to determine how that might play out in the next Legislature. The actuary was asked to attend this September 24 meeting and present the experience study a second time. Following the presentation, the board voted to leave the current assumption rate at 8 percent, as you know. So during the meeting, the actuary suggested that we change the plan's amortization period method from level dollar of payments to level percent of payroll. We were using the level dollar method, which is a much more conservative strategy and not as common among public plans. The Retirement Committee was receptive to this idea because it would help improve funding and it was passed in the 2013 Legislature with other important benefit changes. Then, in 2013, the PERB changed actuaries to Cavanaugh Macdonald. One of the first items we talked about with the new actuaries was, should we be changing the assumed rate? Based on a review of the 2012 experience study and the 2012 Aon Hewitt capital market assumption, Ms. Beckham and Dr. Banister believe the assumed rate of return was reasonable and, therefore, advised the board to wait until a comprehensive analysis could be completed in the next experience study. And they will be explaining that in their testimony. Also, in June of 2013, the annual investment return was 12.7 (percent) for the fiscal year. It appeared there was no rush to change the assumed rate. Important benefits changes had been made and things were starting to turn around. In 2014, the annual investment return was 18 percent. The PERB continued to monitor the 5-year, 10-year, 20-year, and 30-year investment returns and looking at the long term and what other states were doing. The long-term rate continued to be above 8 percent. The PERB continued to consult with the actuary. The PERB did not want to react to short-term market volatility caused by this unprecedented financial crisis in 2008 and '09. During the time, the PERB regularly communicated with the Retirement Committee, testifying at hearings, presenting our annual reports and our actuarial valuations, and at monthly PERB meetings and the annual PERB retreat. NPERS director and legal counsel communicated regularly with the committee's legal

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counsel on retirement matters. During this time period, the Retirement Committee did not express a need to lower the assumed rate, at least not to the PERB. In 2014, Chairman Blank appointed an assumed rate committee to review the assumed rate knowing that the Investment Council was concerned and other states had lowered their assumed rates. We consulted with our current actuaries regarding these actuarial assumptions. Judge Randall Rehmeier chaired the assumed rate committee, researched the laws, and recommended we follow the board Policy 8 which states that the board review the actuarial assumptions used to determine the funding needs, on a regular basis, but change those assumptions only on the basis of a recent actuary experience study and if the actuary...or if the actuary recommends a review due to significant changes in factors used to determine the assumptions. An experience study shall be conducted every four to six years. And that's standard practice with all of the public retirement plans that we work with. This board policy was put in place to make sure the PERB thoughtfully considered the actuarial experience and made an informed decision. It also prevents the PERB from making a snap decision based on emotion or politics. The PERB determined that the 2012 experience study was outdated and should no longer be relied upon. The board approved the recommendation of the assumed rate committee to keep the assumed rate at 8 percent and moved up the timetable for the experience study to 2016. We requested and received the appropriation in our budget to fund this study. A report of the assumed rate committee was provided to Senator Nordquist as well as Senator Mello and Governor Ricketts. At no time until now has the Retirement Committee communicated any concern or urgency to change the assumed rate or that the PERB had not been performing their duties. And they indicated that they were fine with us having the experience study in 2016. And I would like to enter for the record a copy of the assumed rate committee report. I know some of you have seen it. I know some of you may have copies. But I would like it to be entered in the record. Changing the assumed rate abruptly not only affects our financial reports; but it does affect our operations, our programming of our IT system. And the actuaries will need to create new factors, conversion factors for some of our benefit calculations and some of our processes. So this doesn't happen overnight. And as I said, we haven't changed our actuarial assumption for a number of years. So we are really going to have to identify what needs will be changed in our computer system. Also, there are statutes that will have to be coordinated and changed according to the assumed rate. The PERB does not understand what is driving the actions of the Retirement Committee. The PERB believes the conclusions and concerns raised by the committee are based upon incomplete facts and focusing on the 2012

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experience study that is questionable and outdated. The board does not understand why the committee is rushing to change the assumed rate without a comprehensive analysis. The PERB has a long history of working with the Legislature, the executive branch, and our plan members, the groups that we work with, the members themselves, and their lobbying groups to make sure that the retirement plans are properly managed and funded. The PERB is authorized in statute to administer the retirement systems, hire the actuary, and approve all the actuarial assumptions. This system, established by lawmakers in the '70s, has worked exceptionally well in allowing the PERB to function independent of political influence. The PERB believes it has fulfilled its fiduciary duty as defined in the Nebraska Revised Statutes 84-1503.02. The board has discharged their duty with respect to the retirement systems solely in the interest of the members and beneficiaries of the retirement systems for the exclusive purpose of providing benefits to members and member beneficiaries. The PERB has acted with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in the capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. And we've pledged to continue to do so. The PERB has complete confidence in our current actuaries as expert professionals with years of experience in public plan actuarial science. They are actuaries for a number of public plans, as you're well aware, in the Midwest, including Colorado, Iowa, Minnesota, Kansas, Omaha, and Lincoln. Their firm Cavanaugh Macdonald is recognized nationwide and contracts with public plans across the country. Ms. Beckham and Dr. Banister are telling the PERB there is no hurry to change the assumed rate without a comprehensive experience study, which will be conducted in 2016 and presented at the August 2016 PERB meeting. Thank you for your time this morning. I would be happy to answer any questions. [LR243]

SENATOR DAVIS: Thank you, Phyllis. I've got one question. Is Pat going to address what she based that, the recommendation, on to not change the rate? [LR243]

PHYLLIS CHAMBERS: Yes, and she has detailed testimony for you. [LR243]

SENATOR DAVIS: Thank you. [LR243]

PHYLLIS CHAMBERS: Okay. [LR243]

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SENATOR DAVIS: Senator Mello. [LR243]

SENATOR MELLO: Thank you, Chairman Davis, and thank you, Phyllis, for being here very early on a Monday morning. I want to walk through a couple components to I guess piece together some of my concern I think in regards to, to some extent, maybe why we're here today and, to some extent, what we can expect moving forward. Your testimony gave I think a glimpse in regards to the issue that I've come to understand in regards to working with our former colleague, Senator Nordquist, of what happened back in the fall of 2012 where based on an experience study the PERB board made a decision, which then rescinded its decision due to political reasons, political reasons because, as you said in your testimony, you were being influenced by the Heineman administration not to lower the rate of return because it was going to have an impact on the budget. First and foremost I guess I've got a concern, and I want to give you the ability to speak on behalf of the PERB board and if PERB board members are here, how can we as a Legislature and how can the public not assume that this is going to happen again in the sense that the one time we thought, based on an experience study that recommended a reduction in assumed rates, you made the decision and then you backtracked because the Governor said, you're going to impact the budget and I can't let you do that, knowing that you're a separate state agency that has a separate fiduciary responsibility to the ratepayer or to the taxpayers, but also to the plan members, more importantly? I'll give you the ability just to explain kind of what was the rationale and thinking behind why did the board decide to rescind it. And if it was purely due to political will that they didn't want to do battle with the Governor at the time, I guess that's an answer that we I think as a Legislature need to know in respects to the future of our retirement system. [LR243]

PHYLLIS CHAMBERS: Well, I think your...Senator, I understand what you're saying about the pressure from the administration and there...it was definitely there. I will also tell you that we also heard from a number of our members and constituents that they did not want us to lower the rate. I will also tell you that in talking with the actuary, you know, he wasn't as confident that it made that much difference if we waited a year. If it was going to cause stress for the state and taxpayers, we could wait a year. And I do think we collectively looked at all those different stakeholders in making that decision. If we were to do it again, we would have definitely waited a month. We thought this was...you know, we were listening to our professional, the actuary,

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telling us there...you didn't need to wait, we need to get these actuary reports going if we're going to have them in time for November. There were just all these various things. So if we were to do it again, I think we would have waited a year and got more feedback from the committee, from the Governor, and from everybody. And that's what we've been trying to do ever since. So when you say, do you have confidence in what we are doing in the future, I do think ever since that time period we have worked very diligently with all the...with the committee, with the legal counsel to try to communicate all of these issues with you and certainly do our best and be transparent about what's going on. And we do have new actuaries that we feel very comfortable with and they are very professional. I think they are...I think you...I hope you feel the same way. [LR243]

SENATOR MELLO: I would agree with you that I think Cavanaugh Macdonald was a great choice in regards to your actuary. I think they provided some great information to this committee and a number of other political subdivisions across the state. Phyllis, I don't...in part because I think that I've always generally think had a lot of respect for how you've run the agency and how the PERB board is operated, I do have to ask you some follow-up questions in regards to what you just said though in respects to wanting to wait a year, so to speak, if that was the mind-set, because--I will give a copy of this to you, I've got two copies--when the Legislature was debating LB553 in 2013, we specifically discussed that waiting-a-year concept in legislative record as we were passing the bill and, thus, overriding Governor Heineman's veto on the pension reform bill saying that we anticipated you wanted a little bit more time based off conversations, thus, we were going to wait a year. That's why we did what we did with LB553: for you to then lower that 8 percent down to 7.75 in 2014. I've got pretty extensive floor debate from questions from other senators, both of Senator Nordquist and of myself, where we both reiterated on the record that your request of waiting a year essentially is why we did what we did and why the funding for the plan was structured the way that it was, because we anticipated the PERB to reduce that rate of return, which kind of leads me to, to some extent, an interim study we had in 2013, LR198, where I asked you a similar question of saying, where are we at in regards to the experience study. And your response was, we just hired Cavanaugh Macdonald, we're just transitioning away from Buck and Associates (sic) and we believe we're going to need a little bit more time to let Cavanaugh Macdonald, to be able to understand and look through our information. But we should see something back probably, maybe we won't see a...something happen before the 2014

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Legislative Session, but we should see something come back in time. Now we're at the point in time I guess where we haven't seen anything come back. I think to some extent now we know it's...we should see something in August of 2016, which will have been four years essentially since this issue started. And my question just is, what can we expect then in the future? If Cavanaugh Macdonald says 7.75 (percent), and to some extent we already did our part as a Legislature of putting in funding to shore up the plan based on the previous experience study but you didn't act on that experience study, what are we supposed to do moving forward in the sense that they come back with an experience study that says the same exact thing in 2012 and we will have wasted four years in theory of what the Legislature already preemptively created in our plan structure based on what we heard from you, what we saw that you were going to do and then you didn't do, then you told us you were going to do it, and then we haven't seen any action since roughly 2000...late 2013? [LR243]

PHYLLIS CHAMBERS: Well, I do think if you listen to Pat's explanations, that may help answer your questions. I don't under...I guess what I would like to say maybe is that there seems to be a communication problem in that I didn't understand from you, I don't think the PERB understood at any point that you expected us to lower that assumed rate to 7.75 (percent) other than in the projections we were looking at using that because it was a more conservative way to go about it. But at no time did you ask. I mean we communicated, like I said, in all of our reporting, in our testimony. We've communicated what we were doing, but at no point did we receive anything from the committee that said, we expect you to lower this to 7.75 (percent) this year. And so now, four years later, we're talking about this with every intent of looking at this. Our experience study may show that it needs to be lowered to 7.5 (percent). We don't know until we do it. But at this point, clearly, why wouldn't you want to look at more recent information and look at the...you know, get all the experience study done and do it the right way? If we made a mistake before, let's do it the right way this time. And I think if you look at what's happened every year, which is what we did, we looked at...we have continued to look at this issue and listen to what people are saying and watch what other states are doing. We can't...we need to go by what our data tells us,... [LR243]

SENATOR MELLO: Absolutely. [LR243]

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PHYLLIS CHAMBERS: ...not what other states are doing. So I'm sorry you feel that way, Senator. I don't know what else to tell you other than we were sincere in our efforts to do the right thing for the systems. [LR243]

SENATOR MELLO: Phyllis, I can appreciate that. I guess I've got some heartburn in general then in regards to an agency such as yours not...knowing you testify on every major bill that comes in front of this committee, I just have the expectation that you follow the status of those legislative bills as they move out of committee and onto the floor of the Legislature and through the legislative process, which is very important in regards to understanding legislative intent, floor debate, conversations that were had between senators with each other as well as when the Governor ultimately vetoed the major pension reform bill and to some extent addressed, but not really addressed, the issue in his veto letter. I guess I've just got concerns in that respect, and maybe that's a conversation the committee can have moving forward in regards to how we can make sure that you guys are following everything we do after it leaves the committee. The question though that I'm going to need a better answer from is, how are you going to stop or how are you going to remove political influence in regards to your decisions as a PERB board? Because nothing you have said this morning has negated whether or not a future Governor may come, knowing that they appoint members to this board, of saying, you will not lower this rate of return because it has an impact on the budget. Obviously, as the Appropriations Chairman I understand the significant impact of that, which is why even when you rescinded your original motion and 7.75 (percent) rate reduction we still moved forward based on thinking you were going to revisit it because you needed some political support from the Legislature to show it was the right decision at the right time. But you were battling a political entity in the administration. How are we going to ever be able to do this moving forward if we know at any given time your board is simply going to say, well, the Governor doesn't want it so we can't do it? [LR243]

PHYLLIS CHAMBERS: I would have to say that I don't know if I can speak for the PERB entirely, but I think they weigh everything that comes across to them and take a look at it. But they have a fiduciary duty and they really do take it seriously. I think they're there for not just their plan, but all the plans. The board members recognize that and so I think you're going to have to trust that they will do the job that you intend them to do. With this process there is political influence. What we're trying to do is minimize that political influence to do the right

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things. And so I think if this can help us all communicate better, that would, you know, certainly help the board in knowing what your intentions are, rather than having, you know, getting a letter from the committee that, you know, clearly came as a surprise to all of us because we thought we were moving. We have a plan. We thought we were moving in the right direction. So I don't...I would ask you to listen to Pat's testimony because she's going to tell you there are some issues with Dave's ...the Buck analysis in 2012 and that is why she did not recommend we go ahead and lower it when she became our actuary, so... [LR243]

SENATOR DAVIS: Other questions? Senator Groene. [LR243]

SENATOR GROENE: Political pressure, that's why Omaha is in a mess. That's why most of the Retirement Committee...retirement funds across the nation are in a mess. Did anybody from the Legislature, the Appropriations Committee approach you, too, about how it would affect the budget, or was it just the Governor and the stakeholders? I think that was prior to Senator...did the Chairman of the Appropriations Committee... [LR243]

PHYLLIS CHAMBERS: No. [LR243]

SENATOR GROENE: ...or somebody approach you and say, well, hey, we can't... [LR243]

PHYLLIS CHAMBERS: No, Senator, he did not. [LR243]

SENATOR GROENE: Oh, good. That's good to hear. What bothers me more than the Governor is this school plan members, the stakeholders coming to you, the beneficiaries telling you that and your listening to that, that they don't want to have their contributions increased because they want to live for the day and not worry about the future. That bothers me more than the government, the Governor coming to you and hearing that, because they're not responsible for the financial position of that retirement, they just reap the benefits. So that concerns me also that you're being influenced by the stakeholders. Your job is to make sure those stakeholders get their payments, not to be influenced by here in the now. Do you understand what I'm saying? You've said here the school plan members communicated their concern about lowering the assumed rate

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and causing another contribution increase. Your job is to make sure if they need a contribution increase to make the fund whole, you just do it or you recommend it. Is that not true? [LR243]

PHYLLIS CHAMBERS: Well, we tell you what the ARC will be and then the Legislature figures out how it will get paid. [LR243]

SENATOR GROENE: Question for you: We went from a level-dollar payment, which was conservative and we've been in good shape in Nebraska comparably. [LR243]

PHYLLIS CHAMBERS: We have. [LR243]

SENATOR GROENE: And then we went to a more common practice apparently of all the ones that are in trouble across the nation of a level percent of payroll. The numbers we have now where we get all these rosy pictures that we're fully funded and stuff, would the numbers be the same if we were still at the level dollar of payment method? Would we be at 8 (percent)? I don't know the answer to this. Would we be at an 8 percent average return above or in the long range if we were still at the level dollar of payment? How does the method of a level dollar of payment and the level percent of payroll, using that method, affect how fully funded we are or if we're actually at an 8 percent return? [LR243]

PHYLLIS CHAMBERS: I think that would be a good question for the actuary. [LR243]

SENATOR GROENE: All right. Thank you. [LR243]

PHYLLIS CHAMBERS: Okay. [LR243]

SENATOR DAVIS: Other questions? Phyllis, I've got just one more and I think it follows up with what Senator Groene and Senator Mello are saying. Your obligation is to see to it that the fund is fully funded and ours is to fund the ARC. That is what our job is. We can't do that without the appropriate information coming from you. You have policy in place that says you will follow the advice of your actuary and you reversed yourself because of political pressure. And again, I'm coming back to this same question that Senator Mello had. How can we trust the

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information that you get to us if you're responding to political pressure rather than doing what your policy describes your obligation, which is to look out for the beneficiaries of the pension plan? [LR243]

PHYLLIS CHAMBERS: Well, on a day-to-day basis that's what we're doing and rarely do we hear from the administration. So in this instance, and I think you would all agree that the economic crisis that we experienced affected our state deeply and it affected retirement plans around the country. And every retirement system experienced the same thing during this time. And so we're not unique. I don't think our board is any less competent or has any less desire to do the right things or their fiduciary duty. I think we all are trying to work together to accomplish that for the members, for everyone involved in this. And we want to make the plans stable; and there were a lot of changes made in those years, during that time period, 2011, '12, and '13. We continue to improve the plans, make them better funded, and hopefully that's what we're doing on a day-to-day basis so...and to the extent we do that, hopefully we don't...and we're communicating. We don't hear from the administration. The only time we hear from them is when there's a budget issue generally, so. [LR243]

SENATOR DAVIS: Are you paying attention to the discussion that takes place on the floor of the Legislature on a fairly regular basis about unsustainable rates? [LR243]

PHYLLIS CHAMBERS: Yes, I have, a recent year, this past legislation, yes. Yes. [LR243]

SENATOR DAVIS: And I'm sure you're aware, you know, our neighboring states, only Kansas is still at 8 (percent). All the other states are much lower. South Dakota is at 7.25 (percent), for example. [LR243]

PHYLLIS CHAMBERS: Um-hum. [LR243]

SENATOR DAVIS: Any other questions? Thank you, Phyllis. [LR243]

PHYLLIS CHAMBERS: Okay. Thank you. [LR243]

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SENATOR DAVIS: Welcome. [LR243]

PATRICE BECKHAM: (Exhibit 3) Thank you, Mr. Chairman. Good morning. Just for the record, again, my name is Patrice Beckham, P-a-t-r-i-c-e B-e-c-k-h-a-m. With me today is Dr. Brent Banister, B-r-e-n-t B-a-n-i-s-t-e-r. We are both employed by Cavanaugh Macdonald Consulting and we are the retained actuaries for the Public Employees Retirement Board. We thank you for the opportunity to be here today to discuss this important subject. We hope our testimony is helpful to you. I think right up-front we need to acknowledge there's not a single right answer with respect to any actuarial assumption. Under Actuarial Standards of Practice, which we'll discuss in a moment, the evaluation of the reasonableness of the actuarial assumptions, including the assumed rate of return, is the responsibility of the actuary who is using those assumptions, and so I think it is appropriate that we're here today to speak with you. At the board's request, we've prepared a letter addressed to them that discusses our thoughts on your letter to the PERB to lower the assumed rate to 7.75 (percent). It includes a significant amount of information we think is relevant to this discussion. For our testimony today, we'd like to just really walk through that letter. We spent a lot of time putting that information together, and I'm not sure I can do a better job without just really walking through that. So the first page and a half is really a summary. So if you would turn to page 2, the section that's entitled "Background," so: The funding of a public retirement system is extremely long-term in nature. The stream of benefit payments for current members can easily extend over 50 years. And when new hires are considered, the stream of benefit payments continually increases, as you can see by the graph on the following page. As a result, the perspective of the actuary, who is trying to develop contributions to fund the benefits, is also very long-term in nature. And when we say long term, we're looking really 50-plus years. In addition, the actuarial valuation allocates the cost of the retirement benefits to different time periods. That cost is then shared by employees and employers. Therefore, the goal is really to equitably allocate those costs. If the assumptions are overly aggressive, it will shift some of the costs to future generations; but, likewise, if they are overly conservative, it will shift some of the costs from future generations to the current generation. So as a result, when we're setting the investment return assumption the actuary generally selects an assumed rate of return that is near the 50th percentile--the median--in expected results. Economic assumptions are some of the most visible and significant assumptions used in the valuation process. The items in the broad economy modeled by these

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assumptions can be very volatile over short periods of time, as clearly seen in the economic downturn in 2008 followed by a rebound in financial markets in the years following. Our goal is to try to find the emerging long-term trends in the midst of this volatility so we can then apply reasonable assumptions again to the long term. Unlike demographic assumptions, economic assumptions do not lend themselves to analysis based solely on internal historical patterns because inflation, salary increases, and investment return are significantly influenced by external forces which are difficult to accurately predict over the long term. The investment return and salary increase assumptions are generally selected on the basis of expectations in an inflation-free environment and then increased by the long-term expectation for price inflation. This approach is referred to as the "building block" approach. The long-term relationship between price inflation and investment return has long been recognized by economists and the basic principle is that the investor demands a more or less level real return--the excess of actual investment return over price inflation. If inflation rates are expected to be high, investment return rates are also expected to be high while low inflation rates are expected to result in lower expected investment returns, at least over the long run. I'd like to speak for a little bit on Actuarial Standards of Practice. These are issued by the Actuarial Standards Board to provide guidance to actuaries with respect to certain aspects of performing actuarial work. Actuarial Standard of Practice Number 27--we refer to them as ASOPs--ASOP 27, is the standard that addresses the selection of economic assumptions for measuring pension obligations under any defined benefit pension plan that is not a social insurance program, such as Social Security. Therefore, the actuarial analysis of the expected rate of return, as well as other economic assumptions, should be performed following the guidance in ASOP 27. With respect to relevant data, the standard recommends the actuary review appropriate recent and long-term historical economic data but advises the actuary not to give undue weight to recent experience. Furthermore, it advises the actuary to consider that some historical economic data may not be appropriate for use in developing assumptions for future periods due to changes in the underlying environment. In addition, with respect to any particular valuation, each economic assumption should be consistent with all other economic assumptions over the measurement period. ASOP 27 recognizes that economic data and analyses are available from a variety of sources, including representatives of the plan's sponsor, investment advisers, economists, and other professionals. The actuary is permitted to incorporate the views of experts, but the selection or advice must reflect the actuary's professional judgment. ASOP 27 calls for the

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actuary to select a reasonable assumption and for this purpose an assumption is reasonable if it has the following characteristics: it's appropriate for the purpose of the measurement; it reflects the actuary's professional judgment; takes into account historical and current economic data that is relevant as of the measurement date; it reflects the actuary's estimate of future experience, the actuary's observation of the estimates inherent in market data, or a combination thereof; and finally, it has no significant bias--it's neither significantly optimistic nor pessimistic--except when provisions for adverse deviation or plan provisions that are difficult to measure are included. The standard goes on to discuss a "range of reasonable assumptions," which in part states, "The actuary should also recognize that different actuaries will apply different professional judgment and may choose different reasonable assumptions. As a result, a range of reasonable assumptions may develop," both for an individual actuary and "across actuarial practice." And I might just mention this is the current ASOP 27 that's in place. The version that was actually in place back in 2012 was much broader as far as its definition of reasonable assumptions. In the letter from the public Retirement Systems Committee, a statement from Buck's 2012 experience study is included that states, quote, based on Buck's modeling of expected investment returns, the current assumption of 8 (percent) does not meet actuarial standards requirement, end quote. We strongly disagree with Buck's interpretation of ASOP 27. Their opinion was based on discounting the expected benefit payments on a closed-group basis at the various expected returns in each future year which were generated by their proprietary economic scenario generator software. So the rates were actually changing kind of every year in the future. Such an approach is not mentioned anywhere in ASOP 27 specifically or by general reference. That statement may have been Buck's interpretation, but it is not required by ASOP 27 in our opinion. Evidently, Buck's interpretation was not absolute because the 8 percent assumed rate of return was used in the July 1, 2012, actuarial valuations. And Buck attested to the reasonableness of all of the assumptions in the certification letters in those reports. Furthermore, we review the work of many different actuaries that practice in the public arena. We've never seen this particular interpretation of ASOP 27 before. It's interesting to note that the data on the investment return assumption in Buck's 2012 experience study again anticipated that investment returns would indeed increase over time, ultimately exceeding 8 percent by 2030. We conclude this section by noting that, under the ASOPs, an actuary must disclose if they are using an assumption which they believe to be unreasonable or not meeting Actuarial Standards of Practice. In our review of the assumptions being used for the NPERS valuations, we have not

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found any assumptions to be unreasonable; and by signing the valuation reports, we are actually certifying to that. And now we consider the information from the Nebraska Investment Council analysis. As stated earlier, the input of the investment professionals is one of the pieces of information that the actuary may rely upon. The Nebraska Investment Council retains investment consulting services of Aon Hewitt. In the 2012 experience study, Buck did not perform any analysis using the capital market assumptions prepared by Aon Hewitt. Again, they used their proprietary software. However, had they done so, Aon Hewitt's assumptions would have produced a real rate of return, net of administrative expenses, of about 5 percent. When combined with Buck's recommended inflation assumption of 3.25 percent, the resulting investment return assumption would have been 8.25 percent. I think this is a really good example of different approaches, different assumptions can create that range of reasonable assumptions. Clearly, since 2011, Aon has dramatically reduced their capital market assumptions, as shown in the table on the bottom of page 5, and I think really this has been kind of a continual trend each year rather than a dramatic shift in any one year. At their meeting in November 2015, Aon Hewitt discussed expected returns for the portfolio of 6.3 percent, which was a 10-year forecast, and 6.6 percent, a 30-year forecast. Aon Hewitt is one of the few investment consultants that provide capital market assumptions for a 30-year time frame. It's evident that there's little difference in the two sets of assumptions. That does lead us to somewhat discount Aon's 30-year assumptions as other investment consultants believe that higher returns will occur in the longer term even if they don't attempt to quantify the longer-term expectations. It's very important to note that Aon's expected returns are based on an inflation assumption of 2.1 percent. So the resulting real rate of return is 4.5 percent under their 30-year assumptions. As seen in the following table on the middle of page 6, although there's some difference in the real rate of return, the most significant difference in the assumptions used by the PERB and the NIC is the inflation assumption. And this situation is occurring frequently in the current time period because of the difference in the time frame and sources of credible data for inflation are different for investment consultants and actuaries. But you can see the difference between 2.1 (percent) and 3.25 (percent) is really where the difference lies. Typically, the capital market assumptions are used to model expected returns for a 50-plus time period in the future and the resulting distribution of returns is evaluated as part of our analysis. While we conceptually like the idea of using a forward-looking model, the weakness with that approach is that the assumptions being used are set by investment managers and consultants who are typically focusing on a much

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shorter time period: five to ten years. Therefore, those assumptions may not be necessarily appropriate for the longer time frame used by actuaries: 30 to 50 years. The fact that the capital market assumptions are short term in nature is evident by the fact that most investment consulting firms--I would venture to say all--change their capital market assumptions at least annually, so it's a challenge to set a long-term assumption when the information from their experts is changing annually, if not quarterly. If the investment return assumption was set equal to the expected return based on the capital market assumptions each year or even in every experience study, it could create significant fluctuations in the system's funded ratio and the actuarial contribution rate. Our goal is to choose an assumption that will be reasonable, again, over the long term with adjustments only when there are compelling changes to investment policy, like asset allocation or evidence of a change in the long-term trends in the capital markets. Based on both Buck's analysis and Aon's capital market assumptions at the time, 8 percent was a reasonable assumption given the inflation assumption and clearly met Actuarial Standards of Practice. I'm sitting with a Ph.D. in statistics though. I'm not even going to try to explain the next section. I'm going to pass it off to Dr. Banister. [LR243]

BRENT BANISTER: Kind of the next section we start getting into a lot of tables of numbers, so I'm going to depart from just saying, reading everything that's here just because of the sheer complexity of it. One of the challenges that we try to look at and say, well, should we be using an 8 (percent) or a 7.75 (percent) assumption is it's very hard if you're just out there observing returns in the marketplace to distinguish the two results over time. It would take...we have a standard deviation of returns, kind of the natural variability of roughly 12 percent, which means we can be plus or minus 12 percent and that represents about two-thirds of the expected returns; plus or minus 24 percent we'd be at about 95 percent of the time. So it's very hard to go out and look and see, take one observation, and draw a conclusion from that. And just to show as an illustration there, there's a table on the middle of page 7 that compares the probability of exceeding a selected return. So you have top row. What's the probability that we exceed 4 percent? Well, if you have a true underlying portfolio that returns 7.75 (percent), it's 63 percent. And if you have a portfolio that returns 8 percent, it's 63 percent. Next decimal place would be different. Okay? So 4 percent, you're going to be equally likely of exceeding that. If we move up to 7 percent, a 53 percent chance that the 8 percent portfolio would achieve 8 (sic) percent, a 52 percent chance that the 7.75 percent portfolio would achieve 7 percent, so again almost equally

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likely. You know, the interesting points might be, hey, at 7.75 percent, hey, there's 50 percent chance that the 7.75 (percent) portfolio will exceed that and a 51 percent chance that the 8 percent portfolio will exceed it. Or, likewise, if we go to 8 percent, it's 50 percent chance the 8 percent portfolio exceeds it and only a 49 percent chance that the 7.75 (percent) portfolio would exceed it. So basically you're looking, if you were to graph the probabilities, what we call a cumulative distribution function of the probability, kind of a smooth line for all these, you can't see the two lines. They're essentially the same line for all practical purposes. It's very hard to observe and conclude one of these is what's really occurring. We could tell after roughly 2,500 years probably which one we have. That's the statistics behind this, so I guess my point being these two assumptions are really not all that different. And that's why when we look at all the analysis that was here they kind of both would pop up in the reasonable range is they are not that different from a "what can be kind of observed in the world" perspective. Next I want to talk about what happens if we make the change because, again, we're not saying that the change should not be made, could not be made. We anticipate we may well be looking at a change in our upcoming study. And so to kind of give a sense here, we don't yet have this, the 2015 results, where we could get those at 7.75 percent. But using some work we did last year with actuarial adjustments, we provided some reasonable estimates that appear on page 8 and the top half of page 9 that outline how the liability changes. Of course, the assets don't change when you change the assumption and whatever you got in the bank is what you got in the bank or this is a smooth method. So the unfunded liability changes how the funded ratios change. Down to the bottom line of how the contributions, the additional state appropriation requirements would change, for the schools, because of the nature of their...the current statutory contribution rates are more than are required for minimally funding this. The change from 8 (percent) to 7.75 (percent) would not have required any additional state contribution for 2015. You know, we'd have to run projections longer term, but at least in the short term there would be no impact from those. From the State Patrol, the requirements would increase from \$2.7 million to about \$3.8-3.9 million, so another a little over a million dollars' additional requirement. And the judges, with the current assumption the court fees are sufficient to cover, but with the 7.75 (percent) assumption we estimate there might be about a \$320,000 approximately--these, again, are rough numbers and could very well change when we actually run the 2015 numbers through this--but in that type magnitude. [LR243]

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PATRICE BECKHAM: There is that two-step increase in the court fees (inaudible). [LR243]

BRENT BANISTER: Yes, yes, the court fee, right, right. Yes, this would be a temporary thing. The court fees are anticipated to step up again, so that would...it would be just a temporary step. Finally, I want to talk about administrative issues. The investment return assumption does play a role in the optional form factors, how the conversions are if somebody wants to elect something other than the normal form of payment, the early retirement factors, the purchase-of-service factors, so that, you know, for the most part those are...some systems have or some of those things are set by statutes, an actuarial equivalent, so there would be potentially a mismatch if we change the discount rate but not those factors so they would...the idea would be they would probably catch up. Again, we're getting ready to do an experience study and the mortality table is likely to change, so I think it would probably not be ideal perhaps to make one change and then make another change and change the factors twice. I think that would cause a lot of confusion to members, to the IT system. It might not be practical to do everything in two steps. That's just something to kind of be aware of. So in conclusion, the PERB has a formal policy in place that requires an in-depth experience study to be conducted every four to six years. We are conducting on the four-year basis here. They've moved it up to the early end. We'll be starting on that, you know...and I guess based on that, you know, our thought is we're very content to wait until the completion of that study before making any decisions so that all of the assumptions--the inflation assumption as well as the investment return assumption, the salary scale assumption--all the economic assumptions that tie together can be moved together and avoid something where we have a mismatch of standards or of assumptions that might actually create some concern for us from an actuarial standards standpoint if they're disconnected from each other. We'd rather approach everything in a unified approach. With that we would welcome any questions you may have. [LR243]

SENATOR DAVIS: Questions? Senator Mello. [LR243]

SENATOR MELLO: Thank you, Chairman Davis. And thank you both again for all that you do. I do have a quick question though to start off. What inflation rate did you use for the recent experience study for the Lincoln Police and Fire that was released in October of 2015? [LR243]

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PATRICE BECKHAM: We did not do an experience study for Lincoln Police and Fire. That experience study was done by a different firm in 2014. We're working on their 2015 valuation. [LR243]

SENATOR MELLO: Okay. [LR243]

PATRICE BECKHAM: And we don't want to tie the committee up. It's pretty complicated. We did recommend a change to their investment return assumption that's...I'm not sure that's public knowledge, so I think I better stop there. [LR243]

SENATOR MELLO: Okay. All right. You'll...I mean we will get...this committee will get a copy of it eventually, I imagine, in regards... [LR243]

PATRICE BECKHAM: Yep. I'm sure you will. [LR243]

BRENT BANISTER: I would think so. [LR243]

SENATOR MELLO: So... [LR243]

SENATOR DAVIS: Senator... [LR243]

SENATOR LINDSTROM: I had a quick question with regards to the inflation rate. Why the discrepancy between the 2.1 (percent) and the 3.25 (percent)? What's that? Why does that happen? [LR243]

PATRICE BECKHAM: Well, again, I don't think we can speak to how the investment consultants set their long-term inflation assumption. And again, remember, most investment consultants don't even have a 30-year set of assumptions. That's just...it's not the world they live in. That's not really what they're trying to focus on. [LR243]

SENATOR LINDSTROM: I see the ten year for the 2.1 (percent). What...the 3.25 (percent), is that 50 years, 30 years? [LR243]

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PATRICE BECKHAM: Three-point-two, it's more of a long term, a 30 to 50 year. [LR243]

SENATOR LINDSTROM: Okay. [LR243]

PATRICE BECKHAM: And a lot of times...again, that assumption was set by Buck. But a lot of times, at least, we look historically over very long periods of time--30-, 40-year rolling average--to see what that looks like. We do consider estimates in the market--you know, what the bond market expectations, what economists say--but we're sort of slowed. Actuaries are not reactive and we're...you know, we don't want to, like, jump from, you know, 3.25 (percent) to 2.1 (percent). [LR243]

SENATOR LINDSTROM: Sure. [LR243]

PATRICE BECKHAM: I mean that's just a huge change. What we...the National Association of State Retirement Administrators does a public funds survey every year. It's very valuable information. You can go to their Web site and access it anytime you want. But we were doing a discussion about a couple weeks ago and the median inflation assumption for the 126 plans that they have in their database from 2001 I think until now decrease from 4 percent to 3 percent. Okay? So that kind of tells you what's...it's been going on in the actuarial world in a more gradual way generally as people have experience studies. You know, we've seen that inflation rate kind of ratcheting down. But for the most part in the actuarial world, I would say the assumptions are somewhere...the low I've seen is 2.5 (percent); 2.5 (percent) to 3 (percent) has become kind of a tight niche there. [LR243]

BRENT BANISTER: I might mention there's one more factor that we would have to consider with our inflation assumption and that is, it's interrelationship with the COLA provision of the plan. And because the COLA by law can't exceed inflation, if we bring the assumption down too low, we begin to potentially reduce liabilities that may or may not be a...you know, that's...this may be where the adverse deviation kind of thing comes into play where we might say we don't want to assume the inflation is so low that you start spending off gains from COLAs below the assumed rate. So we'd have to factor that in as well. We might choose to keep the COLA on the higher end of a reasonable range because of its impact with the...or the inflation assumption

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towards the upper end because of its impact on the COLA. So we have to factor all of that in.
[LR243]

SENATOR LINDSTROM: Okay. Thank you. [LR243]

SENATOR DAVIS: Senator Mello. [LR243]

SENATOR MELLO: Thank you, Chairman Davis. And page 6 you really did me a favor in regards to the one question I wanted to ask, which was the difference between essentially the economic analysis from the PERB and the NIC. And you pointed out a little bit more succinctly, in regards to the differential, the estimated investment returns. I understand that you're contracted obviously from the Public Employees Retirement Board, so essentially is a contracted service that you provide for actuarial services. But this really comes to I think a bigger question that we've wrestled with in conversations before in this committee in the sense of, where do we as policymakers start to look in regards to who may be right, who may be wrong in regards to these estimated investment returns? Because just looking at the numbers that you've pointed out, which we already knew from previous information, the Investment Council's return is sizably lower I would say than what the Public Employees Retirement Board is estimating. And knowing both are independent agencies that are...have boards that are appointed by the Governor but they operate independently of how they choose to conduct their business, where do we try, so to speak, to mitigate or to find a...find, so to speak, the middle in between what the Investment Council is suggesting they think is going to be a rate of return and what you as the actuaries on behalf of the PERB board is saying, here is what we think that you need to plan on for your long-term estimated rate of return? I'll ask the same question of the SIO when he comes up as well.
[LR243]

PATRICE BECKHAM: Yeah. And I think that's a challenge. It's a challenge I think everybody is struggling with and I think it really is a short-term versus a longer term focus. You know, maybe inflation for the next 30 years will be 2.1 percent. As a person who will be retired in that time frame, I hope they're right. I don't think it's going to be. I'm not planning my retirement assuming that. So obviously, personally, my assumption is that 3 percent seems much more reasonable. Has it been low the last 20 years? Yes. That might almost argue that if it, you know, reverts to the

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mean or the normal that it will be higher. If it's low for the next 30 years, we're looking at a 50-year period where it's been 2 percent or less and I just think it's unlikely. So again I think as actuaries, and we always say long term, but that's why we always say we're talking 50-plus years because, for most of us, long-term planning personally is 10 years, you know. But for this it's much, much longer time frame. And the system essentially is a perpetuity. It goes on forever. And we make changes as necessary but we're avoiding kind of that knee-jerk reaction. And, you know, if you go back to the 2011 assumptions that were from Aon Hewitt, and I mean no disrespect by this, want to make clear we're not criticizing at all because I really think the purpose of the investment consultant is much different than the purpose of an actuary, but the expected return at that point in time, which has not been that long ago, was 7.5 percent. Okay. So if that's a long-term assumption, four years later it's 6.6 (percent), for an actuary that's problematic to resolve that. So I mean we struggle with this kind of the same way you are, and I think there has to be some trust. You know, the PERB is a group that really takes the time to try to decipher all this information and they're looking at the liability side as well as the asset side. The Investment Council is really focused on the asset side. So it's not an easy issue and to delve into it takes a lot of time, as unfortunately you're experiencing this morning. This is just a taste of what an experience study goes into as far as the in-depth nature. So I think a lot of it is long term, shorter term. I don't know. Brent, do you have anything to add? [LR243]

BRENT BANISTER: No. I think really that that really is a lot of the difference is we are...we're doing this for two different purposes. They're trying to determine, how do we allocate the assets now so that over the next few years we can make the most money? Okay. That's really the goal of the investment consultant. We're trying to say what's going to happen over the next 30, 50, 70 years so we don't inappropriately shift costs because if we say, well, you know, it doesn't look real good, then we're going to make life really great for the future people at the expense of today. If we do it the other way, you know, it's a problem too. So we're really trying to balance that. You know, what has happened? Well, you know, over the long term things have been...have done well and, you know, the same thing happened, you know...I remember the late '90s. You know, we had people saying, oh, returns are going to be great, going to be great. We didn't move our rates up in anticipation of, you know, things are always going to be good. And so likewise we're a little...we're probably slower to move it down just because everybody says, oh, things are always going to be bad in the future. Long term is really what we're trying to look at. [LR243]

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PATRICE BECKHAM: And those kind of average out over the long term. [LR243]

SENATOR DAVIS: Senator Groene. [LR243]

SENATOR GROENE: The question I asked earlier of the...changing from the level dollar of payments to the level percent of payroll, what does that affect more? And does it affect our...the rosy picture that we're fully funded or the 8 percent? Probably the rosy picture, right? [LR243]

PATRICE BECKHAM: And let's...you actually have three different systems so you kind of have a different dynamic. So for the school system, which is, you know, the largest and the biggest payroll, let's be honest, that's funded on, you know, fixed contribution rates from the members, the employers, and the state. So when you're looking at the 30-year projections, those are being driven by the fixed contribution rates coming in. We had no additional state contributions when I shared that information with you in November, right? So if you change to...back to level dollar, it would change the actuarial contribution rate. But to the extent it's unlikely with that margin, it's unlikely that would create any additional state contributions in the future. So the projections I think are fine... [LR243]

SENATOR GROENE: Either way? [LR243]

PATRICE BECKHAM: Either way--they don't change. And again, if you change the 7.75 (percent), we...you know, the numbers Brent went over with you are the snapshot right now. [LR243]

SENATOR GROENE: Then why... [LR243]

PATRICE BECKHAM: We'd have to have a projection to see, but... [LR243]

SENATOR GROENE: Then why did the previous testifier say that level dollar payment was more conservative? And what's the definition of that term "conservative" in relationship of these two methods? [LR243]

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PATRICE BECKHAM: So if you step into the arena with State Patrol and judges where they're...the actuarial contribution rate, if there's additional, if it...let me put that a different way. If there's a shortfall between the actuarial contribution rate and the statutory contributions, the state makes an additional contribution. In that situation a level dollar contribution, level amortization payment will...it will fund the UAL more rapidly. Okay. The dollar payments are higher in the initial years. So it might create additional state contributions sooner and then, you know, less goes in later. It's a timing--pay me now, pay me later, pay me later with, you know, interest at 8 (percent) or 7.75 (percent), wherever you're at. [LR243]

SENATOR GROENE: Another question: The price inflation being higher helps us actually, your assessment, because we're not surprised all of a sudden. You're already figuring in a higher COLA than what inflation has been. So in the long run you're actually being more conservative by saying the inflation is higher. [LR243]

PATRICE BECKHAM: It gets very difficult when you step into the...it's a set of economic assumptions because inflation is going to touch them all. [LR243]

SENATOR GROENE: On COLAs, yeah. [LR243]

PATRICE BECKHAM: It's going to touch the COLA. It's going to touch the salary increases because in general, if price inflation is higher, there's pressure for wages to increase. [LR243]

SENATOR GROENE: And that was my next question. Your assumption on salary increases, is that on actual reality when you hear that Omaha is going up 13 percent over the next three years and Lincoln is up to, I don't know, what, 4 or 5 percent increases? Are you using actual or are you using a national figure on what average salaries are going up? [LR243]

PATRICE BECKHAM: No. The salary increase assumption, that actually sort of has two pieces. There's kind of a macroeconomic part where wages in general are influenced by what's happening in the economy. Part of that is price inflation. Nationally, if price inflation stays lower, there is going to be less pressure for wage increases everywhere, right? [LR243]

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SENATOR GROENE: Yes, but it seems that inflation in the school systems has been higher than in the free-market sector. [LR243]

PATRICE BECKHAM: Right, and... [LR243]

SENATOR GROENE: So you're using a free-market number of... [LR243]

PATRICE BECKHAM: Well,... [LR243]

SENATOR GROENE: Are you using the actual figures when Omaha and Lincoln raises their rates? Well, Omaha is not involved in this, but Lincoln. [LR243]

PATRICE BECKHAM: Okay. So part of it is kind of the general economy, and then there's what we call a merit scale, which is a second piece, the salary increase, which is how they change over time, you know, longevity and promotions, changes in position. [LR243]

SENATOR GROENE: A couple hypothetical questions. The minimum wage went to \$9, so the noncertified staff, you could look at it two ways, couldn't you? They're paying in more now. If they were making \$7.25, they're paying in more, but there might be less employees. My question is this: If somehow, hypothetical, we could, instead of the inflation, wage inflation on the top end of the pay scale the Legislature could phase...could push more equitable from beginning teacher to a 30 year one raise, wouldn't that affect us a lot and help us out a lot that those early employees would be paying more and the top end wouldn't be getting such a big payout because of that five-year average or the three-year average? [LR243]

PATRICE BECKHAM: I think over the long term it probably is a wash, I mean the ultimate benefits. [LR243]

BRENT BANISTER: Yeah. If you were to flatten the pay scale, you know, I mean, at the ultimate--I'm just trying to think out loud here--if we ultimately go...they all get paid the same, we have no merit increase,... [LR243]

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SENATOR GROENE: I'm not advocating that but... [LR243]

BRENT BANISTER: No, no, but I'm just trying to... [LR243]

SENATOR GROENE: ...flatten it... [LR243]

BRENT BANISTER: ...make sure I get the math here right. I think you would end up...it really would depend on where you put the end. If you leave the end where it is, the total benefits are going to be the same. In other words, if the file...if the teacher ultimately ends up earning the same amount, the benefits paid would be the same. You would have collected more money. If you bring the... [LR243]

SENATOR GROENE: That's what I'm saying, but it compounds if you get... [LR243]

BRENT BANISTER: If you bring the ultimate teacher down, then you would pay less benefits. You'd probably collect about the same. [LR243]

SENATOR GROENE: Because you're saying the inflation here on the top end is not offset...is...offsets the payment because it's a percentage of pay on the lower end. [LR243]

BRENT BANISTER: Yeah. It would be a very complex calculation. [LR243]

PATRICE BECKHAM: Yeah, I think... [LR243]

SENATOR GROENE: But the problem is the beginning teacher paying more in earlier is compounding for 30 years where the top end is not compounding when they get the big increase and the top end is only compounding for two years. [LR243]

PATRICE BECKHAM: Going to change the rate so (inaudible). [LR243]

BRENT BANISTER: Right, but...yeah, it would change the normal cost rate, so the whole calculation would change, the liability would change, it would...yeah, and... [LR243]

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SENATOR GROENE: Well, just a hypothetical and probably never going to happen but...
[LR243]

BRENT BANISTER: Yeah. It would totally change things. [LR243]

SENATOR GROENE: All right. Thank you. [LR243]

SENATOR DAVIS: I've got a couple questions, then I want to hear from Michael. But you expressed I guess we'll say grave concern about the Buck report from 2012, correct? [LR243]

PATRICE BECKHAM: I wouldn't say grave concern. I would say we disagreed on their reference to ASOP 27 in the fact that the 8 percent was not compliant. That's our only issue.
[LR243]

SENATOR DAVIS: So why was that never brought to the Retirement Committee, your concern with that? [LR243]

PATRICE BECKHAM: I don't...I guess from our perspective, we were asked by the PERB whether 8 percent was a reasonable assumption and we were comfortable using that until the next experience study. And our answer after we reviewed the Buck experience study and, again, the Investment Council's expert's capital market assumptions that were in place at that point in time was that it was fine, 8 was reasonable. And I don't know that we felt that there needed to be...you know, we needed to go back and formally disagree with a report that had sort of...was past its usefulness. [LR243]

SENATOR DAVIS: So when you go back through the notes, the minutes and the notes that were taken by PERB and the discussions, it looks to me like the question that was asked of you was what is the ARC going to be if we have a lower rate rather than should we have a lower rate.
[LR243]

PATRICE BECKHAM: I think we formally provided numbers using a different assumed rate of return, but I know we had several discussions about the 8 percent. And I can't...you know, my

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memory is not so good. I have three kids. So I don't know when that happened. But we clearly discussed the 8 percent. [LR243]

BRENT BANISTER: And again, under actuarial standards we have to at least review all the assumptions every year. You know, we don't...the requirement is not that we do a full-blown experience study. But if we in any year find any assumption to be unreasonable, we either have to say it's not reasonable or we have to change it. We're not allowed to use something if we don't believe it is still valid this year. [LR243]

SENATOR DAVIS: And so in light of that, then Cavanaugh Macdonald does a lot of other state plans, some of whom, or all of the other ones that Phyllis mentioned in her testimony with the exception of Kansas, are much lower. So do they use the same standards then to evaluate each plan? [LR243]

BRENT BANISTER: The same standards are used, but they don't necessarily all have the same asset allocations. So... [LR243]

PATRICE BECKHAM: Or the same capital market assumptions. [LR243]

BRENT BANISTER: Or the same capital market assumptions, yeah. I mean all those things can influence. That's why, you know, there's not a single number that we say, boom, here it is for everybody. Everybody is not the same. [LR243]

SENATOR DAVIS: And so just to get back to that question that I asked just a minute ago one more time, so is there a written...did you send a letter to the PERB saying, we think we're good with the 8 percent rate after the 2014 study? [LR243]

PATRICE BECKHAM: After the 2014 study? [LR243]

SENATOR DAVIS: The study, '14, that PERB put together, I believe,... [LR243]

PATRICE BECKHAM: Oh, the assumed rate committee. [LR243]

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SENATOR DAVIS: ...the committee to look at the rate. And I think they asked you what the ARC was going to be if they lowered the rate. [LR243]

PATRICE BECKHAM: No. I don't know that we had a formal return. You know, hindsight is 20/20, so I'm sure we're all realizing that would have probably been a good idea. I think there was a telephone call and I think I was not on there. [LR243]

BRENT BANISTER: Yeah, I was on that. [LR243]

PATRICE BECKHAM: You want to... [LR243]

BRENT BANISTER: Yeah, I mean we discussed it but, again, I don't know that we...I don't think we...I don't have any recollection of, you know, expressing an opinion directly. But we did sign the 2015 report in which we say that's a reasonable assumption, you know, it's in that range,... [LR243]

PATRICE BECKHAM: And the '14. [LR243]

BRENT BANISTER: ...and the '14 report as well. So even though we don't have a letter that says that, we have said this is something that we still believe is reasonable. It doesn't necessarily mean it is the single best number, but it's reasonable. You know, it's...and we will evaluate every year in addition to the experience study, which is a more comprehensive study this year. [LR243]

SENATOR DAVIS: Thank you. If there's no other questions, I guess...Senator Mello. [LR243]

SENATOR MELLO: Thank you, Chairman Davis. And I guess this is, to some extent, you heard the questions that I asked Phyllis in regards to the concern I have in regards to so you conduct an experience study released in 2016. To some extent, the board chooses not to implement it. And that's the question that I've got, essentially. Regardless of your opinion of Buck's experience study or not, I mean, I've had nothing but good experience with you, but I think when a new firm

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takes over for the old firm, I'm not shocked that the new firm thinks the old firm did a lot of things wrong. [LR243]

PATRICE BECKHAM: I don't think we said that. (Laugh) [LR243]

BRENT BANISTER: No. [LR243]

SENATOR MELLO: Well, that you have a different way of looking at the world than the previous firm, maybe that's a better way to say it. But the concern I've got though is the board's decision not to implement the previous recommendations. You provide another recommendation later this summer, next fall where this committee will hear it. What's to say that the PERB board chooses not to implement your recommendations? And the concern I've got to some extent is...evolves, as I mentioned earlier, the intersection between what the Investment Council is saying that they think they can return short term and long term. I mean 10 year and 30 year. I mean 30 years is a long-term estimated rate of return, I would say, of what they think they can produce for the state. What the PERB board is saying through your recommendations: We think we can still assume this rate of return. And even whatever changes that you may or may not suggest, they just say, yeah, we're going to stay where we're currently at with the 8 percent rate of return. The concern I've got is that there seems to be so much inertia with different entities that no changes essentially could always just happen regardless of what the Investment Council suggests, whatever you suggest. The PERB board can simply say, we're going to stay at where we've been at because we think to some extent this is...we think that we're fine where we're at based on a long-term assumption somewhere down the line. And Phyllis I think, to some extent, said that they will wait to see what you have to recommend. Is that...I mean indulge me a little bit in the sense that I know that you are obviously a contracted company with the state so to some extent all you can do is provide your professional recommendations. But if they choose not to take your professional recommendations over the next year with the experience study, what do we have left in regards to this committee to consider then? I mean that's the policy issue I keep wrestling with, which is we've turned our backs on one experience study, regardless of whatever reason why. Who is to say that we won't continue to do that when the Investment Council has consistently, and this will be my eighth year in the Legislature where they have come...the previous State Investment Officer has consistently come and said, we think we will not be able to

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get an 8 percent rate of return, essentially since I've been in the Legislature. And I...that's something that colleagues of ours not on this committee are listening to as well and they are questioning us in regards to what are we doing to try to address the differences between what NIC is saying, what PERB saying. And now the PERB is saying they're going to rely on you and this experience study to essentially be the end-all, be-all foundation of moving forward. And so I think, I mean, without putting extra pressure on you in regards to whatever is going to be in the study, I think there is a legitimate realization between us in the Legislature that this study will in theory have a fairly large ramification moving forward to the future of the state's retirement system. So I'll give you the ability to talk a little bit maybe about where you think you're at with the experience study, what you anticipate, if anything, and what, if anything, will be your recommendation, so to speak, of how we as policymakers can understand more of your experience study when you give it to the PERB board moving forward. [LR243]

PATRICE BECKHAM: Okay. Appreciate your question, Senator Mello. And I guess I would like to just point out I think the challenge exists across the country. I mean most public retirement systems are governed by a board such as the PERB. And those folks are personally liable. They're fiduciaries. And every board I work with takes that very seriously. They don't take it lightly at all. They weigh a lot of factors. They have a lot of difficult decisions. And I do think perhaps kind of what happened in the '12, '13, '14 time frame was probably complicated by the fact that, you know, we changed actuaries, even though we're delighted that happened. I do think that probably made it a little...it was a little disjointed perhaps. You are correct, we provide our professional advice and we make recommendations, and that's all we do. You know, almost every client we work with, the board ultimately is responsible for selecting the assumptions. Do the boards normally go along with the actuarial recommendation? Yes, not always. I mean we've had situations where boards did not adopt the assumptions that we recommended, and there were reasons for that, but it does happen. You clearly are tuned in and aware of the experience study. I know it's probably not on anybody's top ten things to do, but if you go to the PERB meeting where that's presented, you will get all the gory details and have excellent knowledge and you'll hear the same thing that the board members are hearing and you'll hear their discussion and have a better understanding. And like I said, the board members that we work with all take this very seriously and I think they do weigh it when making decisions. So I don't know for sure what the board will do, but I think probably, looking at what happened last time, it would be better to hear

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the results of the experience study in August, not make a decision until September. I mean it's sort of overwhelming. You have to listen to like an hour-plus of this heavy-duty technical actuarial stuff. It's hard to kind of process it all. You need it to gel and then kind of come back and revisit it. So I think that will...alone will help kind of solidify their discussion and their decision. And sometimes they'll ask for additional information, and so we could bring that back to the next board meeting. I don't know that we're really in a position to say what we think the results of that study will be until we do that study. I think Brent alluded to I think we do expect there to be some changes on the mortality assumption. Again, I think we have a different philosophy on mortality improvement than Buck had. And I think you'll see that in the mortality assumption. [LR243]

SENATOR MELLO: Will you take into consider...do you anticipate the new experience study taking into consideration the Investment Council's, their reports and their projections? I mean is that something you anticipate utilizing... [LR243]

PATRICE BECKHAM: Yes. [LR243]

SENATOR MELLO: ...their information as well in regards to how you arrive at your analysis? [LR243]

PATRICE BECKHAM: Yes. Yes. For our analysis on the investment return assumption in particular we will heavily rely on the capital market assumptions from their expert, Aon Hewitt. We often kind of look to other experts to kind of see what their assumptions, what return their assumptions would produce. And then, like we said, we kind of look at the distribution of returns and look around that 50th percentile result. So, yes, we definitely will be taking that into consideration. Anything you want to add, Brent? [LR243]

BRENT BANISTER: Yeah, I was going to say the one thing where I think there might be the most chance of there being a difference would be the inflation because of the very long-term nature we take with that. And so we may even agree with them on the same real return. But if our inflation assumption is, say, 50 or 60 basis points higher than our long-term return, might be

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50 or 60 basis points higher because we have to keep the assumptions internally consistent.
[LR243]

PATRICE BECKHAM: And our...that would produce higher salary increase assumptions...
[LR243]

BRENT BANISTER: Yes. [LR243]

SENATOR MELLO: Uh-huh. [LR243]

PATRICE BECKHAM: ...and potentially a higher COLA assumption. So it's not all one-sided.
[LR243]

BRENT BANISTER: No. [LR243]

SENATOR MELLO: Yeah. [LR243]

SENATOR DAVIS: Thank you. [LR243]

PATRICE BECKHAM: Thank you. [LR243]

SENATOR DAVIS: Michael. [LR243]

MICHAEL WALDEN-NEWMAN: (Exhibit 4) Mr. Chairman, members of the committee, good morning. For the record, my name is Michael Walden-Newman. I'm the State Investment Officer with the Nebraska Investment Council, one year this month. It's great to be in front of you. The last name, the name is M-i-c-h-a-e-l. I have a hyphenated last name. It's W-a-l-d-e-n, hyphen, N-e-w-m-a-n. Mr. Chairman and members of the committee, I picked up the message Friday morning to...the invitation to come before the committee today and what I thought would be most efficient was to put together this one-page sheet for you recapping the Investment Council's activities over the last year regarding the capital market assumptions and expected returns for our portfolio. I sent your legal counsel a copy of that and then corrected a figure over the weekend

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when I was looking at it at home, so I want to make sure that you have the correct copy. I believe you do. And I'll note which correction I made when I get there. I thought it might be best if I just went quickly through this--it's one page with several bullets--and then at the end take any questions you might have. Does that sound good, Mr. Chairman? [LR243]

SENATOR DAVIS: Sounds great. [LR243]

MICHAEL WALDEN-NEWMAN: Okay, terrific. To cut to the chase, when we talk about 8 percent return, the Investment Council does not think we're going to make 8 percent. Mr. Chairman, committee members, we don't think we're going to make 8 percent over the next ten-year period. We don't think we're going to make 8 percent over the next 30-year period. We look at this each year, the expected return of the portfolio. And again, this is my first year here, but it's no different than in the ten years I ran money for the state of Wyoming's permanent funds. We want to look at this each year so that we can, not from the return, but so that we can monitor the risk in the portfolio. That's the number that I look at first, because the first rule in investing is to not lose the money. And so the Investment Council and I, and we're a good fit that way, are managing this portfolio to risk and reality. So we start with the risk appetite that we have for investing the funds. And risk means, what's the likelihood that you could lose it? And it translates into the variability or volatility in any given year in the returns of that portfolio. So the first bullet is, and you've seen this in the materials we sent to you after our retreat and you've seen an update here that was presented on November 16 at a joint meeting of the Investment Council and the PERB board, that we expect the return to be 6.3 percent over the ten-year period with a 12 percent volatility, which gives you this range in any given year of being down 6 percent or up 18 (percent), and over 30 years a...6.3 (percent) for 10 years, 6.6 (percent) for 30 years with a 12.5 percent volatility with the range in returns you see in any given year. The next section of this, the next bullet, shows the current asset allocation of the pension plans; the return expected for each asset class from Aon Hewitt, our consultant; the volatility of that class; and then the returns. And all of those then roll up to this expected range over the ten-year period. It's been mentioned earlier, and it is true, that, while I've been here one year, you all, who have been here longer, have seen these numbers decline over the last five-year period. In plain English, we believe that the pensions have between a one-quarter chance to a one-third chance of making 8 percent. There's a possibility, but it's between a third and as low...and a quarter chance of making

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that 8 percent. There are questions and there are other consultants that the Investment Council could use. We used a different investment consultant when I was at Wyoming that I had a lot of respect for. You know from I think prior testimony from me before this committee that I knew in my former life Aon Hewitt and contracted with them for some piecework in Wyoming and have a great deal of respect for them. And they were in serious consideration by the state of Wyoming to be our investment consultant. We want, though, to make sure that they're not an outlier in their return assumptions, in their methodology, and the way you test that is to compare their return assumptions to a broader range of investment consultants. And they include in their report to us this year that their numbers are in the mid to more conservative range among 25 investment consultants. And we could have asked for the same information. I include then a bullet of what our returns have been for the pensions. You can see through June 30 numbers recently: 11.5 (percent); the 20...the 10-year, 6.9 (percent); 20-year, 7.8 (percent); and over a 30-year, 9 percent. But I think the telling which completes and bookends this crib sheet, if you will, for you of our materials over the past year are that, how would you get, if we managed to an 8 percent? Which is not what we do. We manage to our risk appetite and our risk appetite is this 12 percent pivot either way around a return. That's our appetite. That's as much risk as we're ready to...willing to take. If we were to manage to an 8 percent return and we asked our consultant that, you can see the asset allocation. We would end up, based on their capital market assumptions of the underlying assets within the portfolio, we would end up with a portfolio that would have 75 percent in illiquid assets. We'd have a 50 percent commitment of private equity versus our current 5 percent, a 25 percent commitment to real estate versus our current 7.5 (percent). Moreover, the fees to manage that would be...go from \$33 million, which is extraordinarily low on a comparative basis for the management of these funds, to over \$134 million. And still this only gives you a 50 percent chance of hitting that 8 percent return. So, Mr. Chairman, members of the committee, these I thought were the highlights of the information that we've done. And when I say "we," again, when I came, my history is short. But when I was new here, Senator Nordquist asked me to come and introduce myself to new legislators in the early part of 2015. And I was brand-new, but one of the things I brought over were the long-term investment return assumptions. I thought, if I were a new legislator, that's one of the things I'd want to know. So I brought that over. Since then we've...it's been the subject at Investment Council meetings. It was important enough then, you all know this, to the council that we put it on our retreat, which is really a word that describes a meeting we have off-site where we have education sessions. This

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was one of the two education sessions we chose this past summer for the council. And the reason for this, and again revisiting once a year as we do, in part to understand the risk, to understand the return, but really to understand the risk and see how our asset allocation should evolve over time based on our risk appetite. The one theme that I've heard time and again--and, Mr. Chairman, you asked--if the Investment Council has taken a formal action. To my knowledge, no. Have we sent a formal letter, a recommendation to anyone about the assumed rate of return for the pension systems? No, I don't believe that's true. But what I do know is this, and we've...and councilmembers have said it. What we don't want is for anyone ever to say, we never heard this from the Investment Council; you sat there, you invested the money, and you never once told us that there was a problem with using the 8 percent return. And so Senator Mello indicated this morning that maybe it's a broken record, maybe you've heard it over and over and over. But I want to tell you, as someone who has made a ten-year commitment to the Investment Council for this job, that you've heard it today and I don't want to be accused personally, professionally, or have the Investment Council, my bosses, ever be questioned as to why they didn't bring to you the fact that we're...we do not believe that the 8 percent return is reasonable. So, Mr. Chairman, that's just a recap of this sheet, and I'd be happy to answer any questions. [LR243]

SENATOR LINDSTROM: I just have a quick question. [LR243]

SENATOR DAVIS: Senator Lindstrom. [LR243]

SENATOR LINDSTROM: Sorry. Thank you, Chairman. Volatility is at standard deviation, is that what you're... [LR243]

MICHAEL WALDEN-NEWMAN: Um-hum. [LR243]

SENATOR LINDSTROM: Okay. [LR243]

MICHAEL WALDEN-NEWMAN: That's correct. Mr. Chairman and Senator Lindstrom, that's a good point. To be perfectly clear, it's standard deviation. It's the measure of how many, within

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two-thirds of the time, do we expect the return to be. So this is one standard deviation now.
[LR243]

SENATOR LINDSTROM: Okay. Thank you. [LR243]

SENATOR DAVIS: Senator Groene. [LR243]

SENATOR GROENE: Let me put it in layman's terms. [LR243]

MICHAEL WALDEN-NEWMAN: Yep. [LR243]

SENATOR GROENE: The actuary is sitting there looking at the bottom line and not looking at what you actually do as far as investment. [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, Senator, yes, I think that's true. We're there to invest the money. We are not, and I've been reminded by the PERB chairman that it is not our role, in no uncertain terms, that it's not our role as the Investment Council to set the rate of return. [LR243]

SENATOR GROENE: So what you just... [LR243]

MICHAEL WALDEN-NEWMAN: And that was...I only needed to hear it put that way to me once to understand what he meant. But these are our expected returns. [LR243]

SENATOR GROENE: Up above here? [LR243]

MICHAEL WALDEN-NEWMAN: Correct. [LR243]

SENATOR GROENE: That's your investment allocation and you're looking at 6.6 (percent). But when the PERB and the actuary look at it, they're saying, well, what's the average of the world of an 8 percent and this is what their allocation would be so...to make 8 percent. But you're not doing this down here to make the 8 percent because it's risky. [LR243]

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MICHAEL WALDEN-NEWMAN: That's correct. [LR243]

SENATOR GROENE: All right. [LR243]

MICHAEL WALDEN-NEWMAN: And to be clear, this is not the PERB's number. None of...this has nothing to do with the PERB. [LR243]

SENATOR GROENE: I understand. [LR243]

MICHAEL WALDEN-NEWMAN: This is a question we put to our consultant... [LR243]

SENATOR GROENE: I understand. [LR243]

MICHAEL WALDEN-NEWMAN: ...if we were to manage to 8 percent: What would your model indicate our portfolio would have to look like? And this is what comes out is this allocation. [LR243]

SENATOR GROENE: But what I'm hearing is you two don't talk, the PERB and the Investment Council, as far as what's actual and what's perceived. [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, to... [LR243]

SENATOR GROENE: I don't want to put you in a tight spot. I'm sorry. [LR243]

MICHAEL WALDEN-NEWMAN: No, no, no. No. Mr. Chairman, that's an absolutely fair question and today is the...I'm thinking today isn't the day to hold back (laughter). I should have mentioned this, the relationship, just at the risk of telling you something you already know. Our board is made up of five gubernatorial appointees on staggered five-year terms. We also have two ex officio members: the State Treasurer, and the director of the pension system, the administrative side of the system. I also, as the State Investment Officer, sit as an ex officio, nonvoting member on the PERB board. So there is an exchange of information that predates mine. I think it's historic. That's, I assume, the reason for that cross-representation on boards is to

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have that communication. The PERB, I go to their meetings. I'll go this afternoon. The PERB comes to ours. They come to our retreat. They've seen this information. Mr. Chairman and Senator, committee members, it's not a surprise to any of us what the Investment Council has in general and what the pension board has. That information is free flowing. [LR243]

SENATOR GROENE: So your answer is you do communicate,... [LR243]

MICHAEL WALDEN-NEWMAN: Absolutely. [LR243]

SENATOR GROENE: ...there's good relations. [LR243]

MICHAEL WALDEN-NEWMAN: Yep. [LR243]

SENATOR GROENE: I didn't want to make a perception that...by my question (inaudible). [LR243]

MICHAEL WALDEN-NEWMAN: No, no, no. As far as relations, they're great. [LR243]

SENATOR GROENE: Good. That's good news. [LR243]

MICHAEL WALDEN-NEWMAN: Yep. [LR243]

SENATOR DAVIS: Senator Lindstrom. [LR243]

SENATOR LINDSTROM: Thank you, Mr. Chairman. See, the allocation 70/30 is what we're at right now, correct? [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, Senator, that's correct. [LR243]

SENATOR LINDSTROM: Okay. How risky will you go? Would it be the 80/20, 90/10, or other? You said that the council feels the 12 percent standard...or standard deviation is I guess palatable or... [LR243]

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MICHAEL WALDEN-NEWMAN: Uh-huh. [LR243]

SENATOR LINDSTROM: ...where they felt most comfortable. How...I guess I don't know the past history. How risky have we been in the past, do you know that, as far as... [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, Senator, I do not know that. I can tell you--it might be helpful--how I intend to manage the portfolio to the extent that the Investment Officer has some say in how the portfolio be managed in the long term in terms of the recommendations I'll take to the council. I intend to manage it the way I did the portfolio in Wyoming, and this was a subject of conversations when I was interviewed by the board. The way I manage the...Wyoming's \$20 billion permanent fund portfolio, which was nonpension money, as you all know--it's the state's mineral money--is that I was there ten years. In those ten years I moved the portfolio from an internally state treasurer managed bond portfolio to primarily externally managed, diversified portfolio across all asset classes. That took five years and it was done systematically, asset class by asset class, year by year, until at the end of five years we had a portfolio that was fully diversified, a mitigated risk that was inherent in the bond portfolio before, and was best suited to carry the state forward. The board for that portfolio were the elected officials of the state, to be clear. In the following five years I did what I intend to do here where I've inherited a portfolio, and that is, rather than nibble around the edges of the portfolio identifying a weak manager here or a weak manager there, we'll undertake a structural review, year by year, of this investment portfolio, choosing an asset class or two a year for in-depth study, a blank-sheet approach, not saying who are weak managers and not, but saying, if we did it today, how would we build this asset class and how would we integrate it into the portfolio or would we? In other words, it is a blank-sheet assumption. And we've begun that process now and chosen our asset class for this year. We know which one we're going to do subsequent to this, so we have an action plan that's mapped out at least over the next couple of years. To your point of how that's...to how that map gets to your question is, when you do that, you can say that you're managing, that you're looking at the asset class itself, but actually it is an annual review of the entire portfolio because you decide how do you want that asset class to fit in and what effect is it going to take in the 70/30 split. In other words, we're doing global equity, how much of that...is it going to remain 15 percent as it is? Maybe, maybe not. And if it does not, that will flow across the portfolio and it will adjust both the risk and the return. Will it deviate much from the

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appetite? In my one year here I may not know everything, but I know my bosses pretty well and they like being on the conservative side of investment management. As I used to say in Wyoming--you've got the same wagon trains going through here as went through Wyoming. I used to use the same analogy with our investment managers from New York, you know, or the West Coast. You know, you can get to California, but the safest place in the wagon train is in the middle. You know, you don't need to be way out front and you sure don't want to be dragging behind. That's how I intend to do it here. [LR243]

SENATOR LINDSTROM: So what you're saying is the Investment Council, with all probability, will never become risky enough or recommend being risky enough to achieve the 8 percent. [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, Senator, that's correct, in my opinion. [LR243]

SENATOR LINDSTROM: Okay, thank you. [LR243]

SENATOR DAVIS: Senator Kolterman. [LR243]

SENATOR KOLTERMAN: Thank you. Along those same lines I see...I know we have 5 percent currently invested in private equities. [LR243]

MICHAEL WALDEN-NEWMAN: Uh-huh. [LR243]

SENATOR KOLTERMAN: Is what you just said, you don't intend to move that needle a lot? Would that be a fair statement? [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, I think that the second topic at our retreat this past summer was private equity, which reflects how important it is as an asset class, how concerned the council is, let me put it that way, that we get that private equity piece of the portfolio correct. I know from the history that there was a lot of discussion. I know from Wyoming there was a lot of discussion to even have private equity in a portfolio. And the

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Investment Council has had private equity in the portfolio for the last ten years and is still...at the retreat we finally, after that ten years, had the discussion and reached the conclusion that, in fact, yes, we are in for the long term in private equity, which was up for some discussion. But does that mean that we'll increase that beyond the 5 percent? Let me put it this way, that's not something I'm going to be bringing to the Investment Council as a recommendation anytime soon. [LR243]

SENATOR KOLTERMAN: Thank you. [LR243]

SENATOR DAVIS: Senator Kolowski. [LR243]

SENATOR KOLOWSKI: Thank you, Mr. Chairman. Michael, thank you for bringing your material this morning. It's really helpful. I think it's good to see where we are and what's happened. Your wagon train analogy is right on target. You'd like to be in the middle and safe. and I think seasons play a role also. You don't want to become a Donner Party. So it's pretty important all the way around. Thank you very much. [LR243]

MICHAEL WALDEN-NEWMAN: Appreciate it, Mr. Chairman. [LR243]

SENATOR DAVIS: Senator Groene. [LR243]

SENATOR GROENE: Where are we at to date this year, return? [LR243]

MICHAEL WALDEN-NEWMAN: I'll be right back. [LR243]

SENATOR GROENE: I don't even know what the market did today but as of Friday, 300-and-some down. [LR243]

MICHAEL WALDEN-NEWMAN: Right. Mr. Chairman, members of the committee, what I...the numbers I have here, I treat the book of record for the Investment Council's returns as the quarterly returns produced by our consultant. That's, for me, the book of record. We don't have the investment returns for December, for the quarter, obviously, but we will and we'll get them to

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you. They...what I do have though today that I brought is our custodial bank, which is State Street in Boston, does monthly performance reporting for us. And I use that and the PERB, speaking of communication, they're very interested in these monthly numbers. And so when I go this afternoon to the PERB meeting, one of the things I'll do is report the most recent month. But I can give you some numbers for, and let's...they're different for...the CBB, as you know, is on a calendar year and the DB plan for teachers and judges is on a fiscal year. The CBB plan, year to date, these are numbers through October, so this is last January through this October, it's 2.5 percent is the total return. The DB plan which, as you know, is...starts in July, the year to date through October is a negative 15 basis points, so 0.15 percent return. Those are through October and we're just a couple of days away from November, so. And I have these and can sure leave Kate a copy, in fact, so that you'd have the monthly totals. Mr. Chairman, I'll be honest with you. I don't put a lot of weight in monthly numbers. You know, my eyes are on the far horizon, quite honestly. [LR243]

SENATOR GROENE: One last question: The 30-year average of ours is 9 percent? You've got here average annual performance as of June 30. The 30 is 9 (percent)? [LR243]

MICHAEL WALDEN-NEWMAN: Um-hum, um-hum, Mr. Chairman. Yes, Senator. [LR243]

SENATOR GROENE: But as Senator "Lindquist" (sic--Lindstrom) said, we don't know what they did in the past. But do you know what the 30-year average of the market is overall? [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, Senator, no, I don't know. That's a good question. It's easy to look up. But, no, I don't know off the top of my head, Senator, sorry. [LR243]

SENATOR GROENE: Thank you. [LR243]

SENATOR DAVIS: Michael, I want to thank you for coming. And you bring some great information to us. In light of your long experience and knowledge about the markets and how things have been for the last several years and looking at some other world data, how often

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should a study be done? Are we doing them too...I mean, are they too far apart at this point? Is a 2012 study relevant to today? [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, I've got to admit, that's a fair question, and so I'm going to think a little bit before I answer. Thinking out loud about it, with all the risk that that brings, I can tell you that's exactly how they did it. I sat in Wyoming. I was the CIO, as I said, for the state's permanent funds that were, when I left, \$5 billion when I started and \$20 billion when I left after ten years, the state's, not because I was terrific, but because the mineral income was coming in that much to Wyoming. Part of the role though is I also sat not as an ex officio member but a voting member as the state treasurer's proxy for the pension board. And so while it wasn't my day-to-day job, I paid attention to the ins and outs of managing a pension program. And I'm no expert, but I'm boning up here, let me tell you. That's how we did it in Wyoming. They did it the same way, the same spacing of studies, and it seems to me to be industry practice. Now, I will tell you this though, that I do not think a reasonable person, a prudent person, which is our standard, that a prudent person would expect the next 10 or 30 years to be like the last 30. [LR243]

SENATOR DAVIS: And in light of the PERB's expected return of 8 percent and your projections around 6 (percent), whatever, 6 (percent), 7 (percent), 5 (percent), does that give the Investment Council a feeling that they have to take risky investments in order to make that return? [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, no. [LR243]

SENATOR DAVIS: So I would say then the committee can anticipate, if the PERB were to stay the course the next time around because of political pressure, at some point plans would be drastically underfunded. [LR243]

MICHAEL WALDEN-NEWMAN: Mr. Chairman, I'd answer that by saying that we intend, as I said before, to manage this portfolio to risk and reality, not to chase a return. [LR243]

SENATOR DAVIS: Expectations. [LR243]

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MICHAEL WALDEN-NEWMAN: Correct. [LR243]

SENATOR DAVIS: Any other questions? Really appreciate your coming. [LR243]

MICHAEL WALDEN-NEWMAN: Yeah, thanks. [LR243]

SENATOR DAVIS: Thank you. Thanks to everyone who is here. [LR243]

MICHAEL WALDEN-NEWMAN: Right. And happy holidays to you all. [LR243]

KATE ALLEN: Any the other testifiers? [LR243]

SENATOR DAVIS: Yeah, and the other testifiers, appreciate... [LR243]

KATE ALLEN: Are there any other testifiers? [LR243]

SENATOR DAVIS: Are there any other testifiers? [LR243]

ORRON HILL: Good morning, Chairman Davis and committee members. My name is Orron Hill, first name spelled O-r-r-o-n, last name spelled H-i-l-l. I'm the legal counsel for the Public Employees Retirement Board. I have been asked by the board to address the committee's concerns regarding whether the PERB is acting in the best interests of the members of the retirement systems regarding lowering the assumed rate to 7.75 percent based upon the former actuary's 2012 experience study. The PERB's appointed members, as has been stated, are to act with care, skill, prudence, and diligence under the then-prevailing circumstances solely in the interests of the members and beneficiaries of the retirement systems when carrying out their fiduciary duty. The PERB is concerned that there is a lot of conflicting information out there in the public regarding what the right assumed rate of return should be for the state of Nebraska. You have heard from many people today--Director Chambers, the actuaries, the State Investment Officer--and they've testified to a lot of different facts that shed light on why the PERB has acted and how the PERB should act in the future. I would like to focus your attention on a few specific things regarding past action first. At its September 2012 meeting the PERB reviewed whether

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changing the assumed rate to 7.75 percent was appropriate. There was a lot of factors that played into that. Stakeholders other than just the members and beneficiaries weighed in on that. And you've heard very educated people talk about how some of those stakeholders weighed in. The PERB consulted with its actuary on the issue. Buck indicated that using 8 percent assumed rate would have a minimal impact on the plan's long-term funding status. And the experience study does show that. I had a long list of references but all of them have already been discussed, so I'll move past those in the interest of time. The PERB did carefully consider what it should do and it did vote to revert to an 8 percent assumed rate. Buck used this 8 percent assumed rate in its July 1, 2012, actuarial valuations of the plan. As the ASOPs require, the actuary must clearly disclose if they are using an assumption that they believe to be unreasonable. Thus, if Buck believed that an 8 percent assumed rate was unreasonable, they should have disclosed it in the actuarial assumed...or actuarial valuations of July 1, 2012. They made no such disclosure. In fact, Buck attested to the reasonableness of the 8 percent assumed rate in the certification of the letters on July 1, 2012. So there's some of our past experience, but let's focus a little bit more on the present and the future, which I think is the valid concerns that the committee is looking at today. What do we do now and what do we do in the future? Most importantly, a lot has changed in the three years since the experience study, which was based upon four-year-old data, was conducted. The PERB's composition has changed. The assumed rate committee constituted and did some research. Plan benefit and contribution structures have been changed based upon the recommendations of this committee. And they were significantly changed in two of the plans and there has been proposed legislation in past sessions to change it in the other plans as well. And most importantly, the PERB has a new actuary, as has already been discussed. That could have been a compounding factor in some of the discussions that went on at the time. The current actuary is very professional and they're a little bit less kind...or more kind than sometimes other people might state it. One of the things that our current actuary said is that they strongly disagree with Buck's interpretation of ASOP 27. In their letter, Ms. Beckham and Dr. Banister opined that Buck's interpretation "is not mentioned anywhere in ASOP 27 specifically or by general reference." Further, Ms. Beckham and Dr. Banister, quote, have never before observed Buck's interpretation of ASOP 27, end quote, during their review of work of other actuaries that practice in the public pension plan arena. This begged the question for me, as I was reviewing these past studies, being the new legal counsel for the organization looking at the past practices and procedures and what had been done: Should the PERB change the assumed rate based upon a

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report that employed a unique interpretation of an Actuarial Standard of Practice? That caused me concern as I looked back, and I rephrased the question in my mind to that of the fiduciary duty that the PERB is held to by statute, that I'm required to interpret for them. And I rephrased the question thus: Would the PERB be acting with skill, care, prudence, and diligence if it changed the assumed rate based upon an experience study conducted by an actuary who used an interpretation of an Actuarial Standard of Practice that is not consistent with the commonly accepted interpretations used by other actuaries in the public pension arena? That was a very concerning question for me as I looked back upon what has happened in the past. The answer that I came up with is, no, I don't think it is an appropriate standard. Under the current circumstances, as we look to the present and the future, the PERB's most careful, prudent, and diligent course of action would be to delay changing the assumed rate until its actuary conducts an experience study utilizing the commonly accepted interpretations of the ASOPs. It's my position that in order to fulfill the PERB's duties it should look at the entire picture, all of the circumstances now prevailing, in making its decision. The PERB, acting solely in the best interests of the members and the beneficiaries of the retirement systems, must take tremendous effort to carefully, prudently, and diligently review the issues since 2012 and the way forward. This includes consulting with the experts on the Investment Council. This includes consulting with the actuary currently providing guidance to the board on what it should do. Mr. Chairman and members of the committee, I know you are concerned about what the PERB will do in the future. I respect that concern. As the legal counsel for the committee...the PERB, it's my job to make sure that they are adhering to the laws that you have put in place. And though I can't predict what the future may hold, what I can tell you is this: It is my job to make sure that they are reminded of that fiduciary duty and every year I take it upon myself to train them and remind them of that statutory threshold. When questioned at the last retreat earlier this year, I was questioned whether or not the taxpayers are someone to whom we owe a fiduciary duty. The plain language of the statute says no. The plain language of the statute says our fiduciary duty is to the members and the beneficiaries. But the taxpayers are an important stakeholder. We are mindful of how the taxpayers are going to help fund this plan and what additional required contributions may be necessary. And so we are cognizant of your concerns. I hope that what you have heard here today has alleviated some of your concern. I hope that you will consider the facts and explanations that were previously presented and that you have a better picture now of

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how we are looking at this presently and will continue to look at it in the future. Subject to your questions, that completes my testimony. [LR243]

SENATOR DAVIS: Senator Mello. [LR243]

SENATOR MELLO: Thank you, Chairman Davis. And thank you, Orron, for being here this morning. Two quick questions based on your testimony: When did Cavanaugh Macdonald advise the PERB that Buck's analysis was not following an appropriate standard in their perspective? When did that occur? [LR243]

ORRON HILL: They...it's my understanding that sometime while the question regarding what additional required contributions was going to be necessary they looked at all of the assumptions that Buck was using and they raised that concern. I don't know the exact date. I wasn't here and I apologize that I'm only looking at what I can review. But that is when they looked at it and raised the concern, as they stated earlier today. [LR243]

SENATOR MELLO: In any conversations that you have been involved in, was there an issue in regards to why this concern wasn't brought forward publicly to this committee through the number of annual reports that this committee hears from the PERB on an annual basis? Was there any discussion at all of saying, we probably should let the Legislature know that we may be operating from faulty information in regards to this Buck analysis? [LR243]

ORRON HILL: Senator, I have not been privy to any conversations that included that topic. [LR243]

SENATOR MELLO: Is that something that we could possibly ask you to find out from Director Chambers, who I know is not here? But I think that's the bigger issue is, if this was a concern now that the PERB is bringing forward, why wasn't this concern brought forward before publicly and/or even privately to this committee for us to know that in the sense of why these changes in theory hadn't been made based on previous reports that we passed legislation on essentially taking those previous reports under consideration? [LR243]

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ORRON HILL: I will certainly discuss that with Director Chambers. [LR243]

SENATOR MELLO: Thank you. [LR243]

SENATOR DAVIS: Senator Groene. [LR243]

SENATOR GROENE: Thank you. Sir, you know, as a layperson, as a taxpayer, we seen Anderson (phonetic), we've seen the national where an accounting firm got very popular because they did what the people wanted them to do. When you made the decision, the PERB made the decision not to go 7.75 (percent), you didn't have any advice from Macdonald yet. Buck was still your actuary. Could you tell me why Buck was dismissed and you needed and the PERB thought they needed a new actuary? [LR243]

ORRON HILL: Senator I was not personally involved with that. It was before my time so I... [LR243]

SENATOR GROENE: Was this issue...you don't know if this issue was why they decided they needed somebody to agree with them? [LR243]

ORRON HILL: I do not know what transpired at the time we changed actuaries. That's the only answer I can give you. [LR243]

SENATOR GROENE: But answer the first question, when the decision was not to use the 7.75 (percent), you didn't have Cavanaugh Macdonald's opinion on Buck's analysis yet because they were your actuary at that time. [LR243]

ORRON HILL: My assumption is that is a correct statement, yes. [LR243]

SENATOR GROENE: Thank you. [LR243]

SENATOR DAVIS: Can I interrupt just a second, Mike? [LR243]

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SENATOR GROENE: I'm done. [LR243]

SENATOR DAVIS: I think Kate knows the history here. [LR243]

SENATOR GROENE: All right. [LR243]

KATE ALLEN: Senator Groene, my understanding is that the three-year contract for the actuary came up just following the experience study--on a normal rotation it comes up that way--and that Buck did not submit a bid to become the actuary. [LR243]

SENATOR GROENE: That clears that up. Thank you. [LR243]

KATE ALLEN: So they were not dismissed. They did not submit... [LR243]

SENATOR GROENE: No conspiracy then. [LR243]

KATE ALLEN: They did not submit a bid. [LR243]

SENATOR GROENE: Thank you for clearing it up. [LR243]

KATE ALLEN: And that's my understanding of what happened. [LR243]

ORRON HILL: What I was going to continue on, Senator, is that the primary actuary from Buck Consultants that represented us is now retired, and that's what I do know is he is no longer in the business of functioning as an actuary. [LR243]

SENATOR GROENE: I want to make sure. I know nothing about Cavanaugh Macdonald. They're a very good firm, I'm sure. I'm not trying to make comments on their practices. [LR243]

ORRON HILL: Understood, Senator, yes. [LR243]

SENATOR GROENE: Want to make that clear. [LR243]

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ORRON HILL: Thank you, Kate. I appreciate that. [LR243]

SENATOR DAVIS: How...thank you for coming, Orron. Do you have knowledge of other states? How often does a board like the PERB go against its actuary's advice? [LR243]

ORRON HILL: I don't have statistics. I attended the National Association of Public Pension Attorneys conference earlier this year. They did not have a specific topic on assumed rate on the agenda, but I did talk at some of the breakfast sessions about, you know, what is the standard practice and how often are the subject matter experts'--that are contracted by the various boards--opinions not considered or considered and then not followed? A lot of it depended upon how the individual retirement system was structured. Some retirement systems managed their investments internally. There was no separate council like we have here in the state of Nebraska. Others had separate councils. And depending on their unique circumstances is how they would respond to those things. The most public of them have gotten in trouble when they have not followed the recommendations over the long term. And I think we've all seen that in the news media, so I don't think there's any way we could deny that. But on an individual basis, one on one, I don't have any statistics with which to share with you, Senator. [LR243]

SENATOR DAVIS: I think it's important for the PERB to understand that when we have the Investment Council saying to do...to try to meet those 8 percent goals is very risky, and then for the PERB to go against its actuary four years ago because of political pressure, it comes down to this, that we as the legislative body are the ones that are responsible for making up that ARC and the PERB's responsibility is to the beneficiaries of the plan, no one else. So I guess it really concerns me that we are seeing the can being kicked down the road in some respects. [LR243]

ORRON HILL: Your concern is noted. [LR243]

SENATOR DAVIS: Care to comment on that? [LR243]

ORRON HILL: Well, again, I can't undo what's been done in the past, Senator. What I can tell you is that I believe my legal obligation as the counsel for the PERB is to constantly remind them of their fiduciary duty. And if in my professional opinion I have concerns about their

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approach to an issue that is very important to this legislative body and is established in law, it is my duty to raise that concern. Now I'm also bound by attorney-client privilege. I am not allowed to waive that privilege; therefore, my discussions will likely happen in a private setting or an executive session because I don't have the authority to waive that. [LR243]

SENATOR DAVIS: And I understand that. [LR243]

ORRON HILL: But I will constantly remind them of that statutory fiduciary duty because that is my responsibility. [LR243]

SENATOR DAVIS: In all of the discussion that took place in 2012 and 2013 and leading up to the reform of the school plan which took place in January 2013, the Legislature and this committee built that entire plan on an actuarial study done by Buck which you refuted the next month. And as far as I know, the committee was never, you know, it was never made plain to this committee that, oh, by the way, we're doing this even though the actuary says...even though the PERB says 8 percent. You follow what I'm trying to say? [LR243]

ORRON HILL: I believe I understand your concern, Senator. I don't know if there's a question you would like me to address. What I can say is I believe that the PERB has opened lines of communication with both the Investment Council and with this committee and will continue to try to leave open lines of communication. I am in the unique position of having a board member still sitting in the room. He is an ex officio member. He has the unique position of having two different legal counsels that advise him depending on which chair he is sitting in at the time. I have met with him, one on one, and with his other legal counsel to discuss some long-term issues for the plan and how he intends to do it as the investment officer, because that is an important factor in my review of this plan. Again, I can't predict what the future will hold, but I can tell you this: I will constantly remind the PERB of its statutory fiduciary duty, as I am required to do. And I hope that that encourages this committee and I hope that this committee understands that I take that seriously. [LR243]

SENATOR DAVIS: Thank you. Any other questions? Thank you, Orron. [LR243]

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ORRON HILL: Thank you, Senator. [LR243]

SENATOR DAVIS: Any other testifiers? If not, that will conclude the hearing. Appreciate everyone coming and good testimony. Thank you. [LR243]