

FY'07 PSPRS FINANCIAL STATUS SUMMARY REPORT

The following is a summary of the principal trends, and the reasons for those trends, with respect to the financial status of the PSPRS-administered defined benefit plans – namely the Public Safety Personnel Retirement System (PSPRS) Plan, the Corrections Officer Retirement Plan (CORP), and the Elected Officials Retirement Plan (EORP).

Financial Trends With Respect to Funding Ratios and Employer Contribution Requirements

As Table 1 below shows, the funding ratios of the three PSPRS-administered Plans have declined steadily over the past ten years. During that time, the Plans have gone from an overfunded to an underfunded situation. Table 1 shows the funding ratios calculated using fiscal year-end market value of assets and also fiscal year-end actuarial value of assets (i.e., an average of the market value of assets and the actuarial gains(losses) over the four years ending June 30th through June 30, 2004 and over the seven years ending June 30th for subsequent fiscal years).

Table 1 – Funding Ratios of PSPRS Plans (Actuarial Value & Market Value)										
Actuarial Value										
Fiscal Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
PSPRS	116.3%	120.3%	124.7%	126.9%	113.0%	100.9%	92.4%	83.2%	77.6%	66.4%
CORP	118.1%	133.5%	140.6%	140.0%	123.8%	114.4%	104.8%	101.1%	93.7%	84.6%
EORP	121.1%	124.8%	130.1%	141.7%	125.5%	118.7%	104.4%	92.3%	89.9%	74.6%
Market Value										
PSPRS	132.2%	132.9%	132.2%	102.3%	77.1%	71.0%	72.4%	69.3%	68.5%	69.9%
CORP	135.4%	147.4%	149.2%	115.0%	87.3%	83.5%	84.6%	86.5%	84.4%	85.8%
EORP	141.0%	140.5%	140.2%	116.2%	86.5%	84.3%	81.5%	77.1%	79.4%	75.1%

As the funding ratios of the Plans have declined, the employer contribution rates for the plans have escalated, as Table 2 illustrates. (The employee rates are fixed by statute and are currently 7.65% for PSPRS, 7.96% for CORP and 7.0% for EORP.)

Table 2 – Employer Contribution Rates By Employer Fiscal Year							
Fiscal Year	2003	2004	2005	2006	2007	2008	2009
PSPRS Rate	3.75%	7.66%	10.05%	12.80%	13.83%	16.52%	21.72%
CORP Rate	1.71%	3.95%	4.07%	5.47%	4.46%	6.72%	8.68%
EORP Rate	7.55%	13.49%	14.54%	20.54%	18.55%	20.21%	28.00%

Principal Reason for the Funding Ratio Declines and the Contribution Rate Increases

During the 1990s, PSPRS annually generated investment returns well in excess of the System's actuarially assumed rate of 9%. As a result, throughout the decade and through FY'03, the System's Plans were more than 100% funded. It appeared that all was well. In reality, however, that was not the case. The financial health of the Plans was increasingly predicated on an investment strategy that entailed an extraordinary degree of risk.

During the last half of the 1990's, the Plans' portfolios were increasingly concentrated and invested in "high tech" securities. But in March, 2000, the "tech" bubble began to deflate. From June 30, 2000 to June 30, 2002, the asset value of the PSPRS Plans declined from \$5.6 billion to \$4.0 billion – an asset value loss of nearly 30%. Not until June 30, 2006 was the market value of assets of the Plans roughly back to where it had been at the end of fiscal year 2000. But by that time, the Plans' liabilities for present and promised future benefits had increased 89%.

Since the System uses a seven year averaging process to determine its fiscal year-end actuarial value of assets, the effects of the 2000-2002 asset value loss will not be fully reflected in the Plans' funding ratios until the end of System FY'09.

When times were good and the System's Plans were over-funded, the employers' contribution rates were abnormally low. But with the rapid decline in the Plans' funding ratios, the employer contribution rates have been increasing in large year-over-year increments. The current aggregate PSPRS and CORP employer contribution rates are 16.52% and 6.72% respectively. The current EORP employer rate is 20.21%. But as a result of the Plans' FY'07 lower funding ratios, these rates will increase to 21.72%, for the PSPRS Plan's contributing employers, 8.68% for CORP employers, and 28.0% for EORP employers, effective July 1, 2008.

Other Reasons for the Funding Ratio Declines and the Contribution Rate Increases

Although the 2000-2002 asset value loss has been by far the major cause of the Plans' funding ratio erosion and the employer contribution rate increases, other factors also contributed. These include:

- The expected less favorable investment environment that caused the System to reduce the actuarial expected rate of return on assets from 9.0% to 8.5%;
- The statutorily required allocation of a large portion of investment returns in excess of 9% to the Plans' Benefit Increase Reserves such that the Reserve assets are not taken into account for funding ratio and employer contribution rate calculations; and
- The increased liability associated with legislated benefit increases, including the PSPRS Deferred Retirement Option Plan (DROP).

The Adverse Impact of Required FY'07 Changes in Actuarial Techniques and Demographic Assumptions

Still another factor contributed to the significant funding ratio deterioration from FY'06 to FY'07. In this most recently completed fiscal year, the System was required to make a variety of changes in actuarial technique and demographic assumptions. These changes significantly increased the Plans' unfunded liabilities. Roughly one-half (2.8%) of the PSPRS Plan's funding ratio decline from the end of FY'06 through FY'07, for example, was attributable to these changes that came out of actuarial audits conducted by the Legislature's actuarial auditing firm, Segal & Co. and by the System's actuarial auditing firm, Milliman Consultants and Actuaries.

Rates of Return on Investments

Table 3 below shows the rates of return of the System and each of its Plans over the one year ending June 30, 2007 and the annual average returns over the three, five and ten years ending June 30, 2007 relative to weighted composite market returns (i.e., “benchmarks”) for the same periods.

Table 3 – Investment Portfolio Returns				
	1 Year	3 Year	5 Year	10 Year
Total Fund*	17.04%	11.42%	11.13%	6.82%
PSPRS	17.06%	11.41%	11.14%	6.81%
CORP	16.77%	11.32%	10.93%	6.76%
EORP	17.01%	11.40%	11.15%	6.75%
Benchmark**	15.13%	9.89%	9.55%	8.03%
* Total Fund returns are gross of fees				
**Benchmark 50% S&P 500, 10% S&P 400, 5% S&P 600, 20% Lehman Gov/Credit, 10% Alternative Investments (Expected Annual Return of 8%), and 5% 91-Day T-Bill.				

PSPRS Asset Management Restructuring

The past practice of managing all the System’s publicly traded portfolios internally has severely limited the System’s asset diversification and caused the System to underperform its public retirement system “peer” group. In order to better position the System to achieve its rate of return expectations, enhance returns and diversify its assets through access to a wider mix of financial markets, the System has begun an asset management restructuring. To date the following has occurred:

- A new independent investment consulting firm (Ennis, Knupp & Associates) was retained last December;
- A new and more diversified asset allocation was adopted in February;
- A plan for implementing the new asset allocation was adopted in May;
- The Board accepted the retirement resignation of the System’s CIO and authorized a nation-wide search for a new CIO using an executive search firm;
- A new custodian bank (BNY Mellon Bank) was hired in August (effective October 1st); and
- Barclay Global Investors (BGI) was approved in May to manage the transition of the System’s equity assets into U.S. and non-U.S index accounts at BGI.

Future steps in the restructuring process include:

- Enacting legislation in the 2008 Legislative Session to give the PSPRS Board specific authority to use external professional managers for the System’s portfolios of publicly traded securities and to give the Board greater flexibility to diversify its asset allocation to reduce risk and enhance potential investment return;
- Completing the contract negotiations with BGI;
- Outsourcing the System’s equity assets into index accounts at BGI;
- Completing the CIO search and selection process;
- Commencing searches for professional investment managers that can actively manage equity portfolios with global mandates and managers that can manage portfolios that have low correlations to equities;
- Review the internally managed bond portfolio and make changes as appropriate;

- Increase commitments to real estate and private equities to achieve greater diversification in those areas.

Expectations for the Financial Status of the Plans in the Future

The funding ratios for the Plans should begin to improve and the employer contribution rates should begin to decline once the 2001-2002 asset value losses drop out of the calculation of the actuarial value of assets (i.e., after the close of System FY'09). The fact that, for the first time since June 30, 2000, the Plans had a market value of assets greater than actuarial value of assets at June 30, 2007 would seem to be a harbinger of an improving trend. The implementation of the System's new asset allocation and the achievement of better-than-expected rates of return on invested assets would serve to accelerate and magnify the expected improving trend.

However, there are two things that could delay the expected improvement:

- A sharp and sustained downturn in the U.S. and global economies and financial markets; and
- Having to reduce the System's actuarial rate of return assumption from 8.5% to 8.0% as was recommended by the actuarial auditing firms Segal & Co. and Milliman.

Options to Moderate the FY'08 Employer Contribution Rate Increases

There are options that may be considered to moderate the increased employer contribution rates that are scheduled to take effect July 1, 2008 (FY'08). These include:

- A legislated maximum that would limit the percent by which employer contribution rates could increase or decrease from one year to the next (as, for example, 2% per year); and
- A legislatively authorized Pension Obligation Bond (POB) initiative that would allocate the bond proceeds to the Plans to improve their funding status and thereby reduce employer contribution requirements (relative to what would otherwise be the case), with the future investment returns on the bond proceeds exclusively earmarked for the payment of principal and interest to the bondholders.