OPERS

Ohio Public Employees Retirement System

August 14, 2017

The Honorable Dave Yost
Auditor of State
88 East Broad Street
Columbus, Ohio 43215

Dear Auditor Yost,

Thank you for your letter regarding the decision by Fitch Ratings to lower the investment earnings assumption used by that agency to evaluate pension liabilities for public plans. Your letter also identified your concern about the investment return assumption used by the Ohio retirement systems. On behalf of the Ohio Public Employees Retirement System (OPERS), I'd like to provide the following perspective as it relates to your concerns.

While articles such as the ones you shared certainly raise questions, it is helpful to understand the background of how we operate. Developing an appropriate funding plan is paramount to our work at OPERS. Our system has a long history of being a fiscally responsible administrator, as we constantly monitor our plan and identify issues in advance of them escalating to a critical stage. OPERS has a proven record of tackling challenges directly and working with our members and stakeholders in doing so. This can easily be evidenced most recently by the pension plan changes and the health care changes adopted by our Board. The pension plan changes reduced our liability by approximately $4 billion while the health care changes reduced our liability by $12 billion. Since implementing perhaps the most dramatic changes in our history, we continue to constantly review the plan – evaluating the liability, benefits and funding.

The plan's funding is largely based on a framework of assumptions. Our Board and staff work diligently with top-level investment and actuarial consultants to establish realistic long-term assumptions. We understand clearly the impacts of assumptions that are too optimistic will result in funding shortfalls. And, since Ohio is unlike most other states in which the employer contribution rate varies based on the funding level, we rely on the legislative process to make necessary changes to the plan design to address shortfalls. Conversely, we also recognize that assumptions that are too pessimistic will result in too drastic of reductions in the plan, which will have a direct and immediate harm to members and retirees.

Even though our 2016 return on investments was 8.22 percent, and 2017 is trending even higher (9.06% year to date through August 11th), our planning focuses on a long-term investment return similar to the timespan of a member's working career. Thus, we strive to find realistic, assumptions that properly consider both short-term and long-term expectations. To do this, we adhere to a dedicated, thorough and consistent process that reviews the assumptions and adjusts them upward

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or downward based upon conditions and expectations. We recognize that no single set of assumptions will be suitable indefinitely; that is why there is a systemic review of all assumptions.

In accordance with Ohio Revised Code (ORC) Section 145.22, our actuaries conduct an annual actuarial valuation. This report is prepared in accordance with actuarial standards of practice promulgated by the actuarial standards board of the American Academy of Actuaries and in accordance with the Governmental Accounting Standards Board (GASB). OPERS Board and staff use this report as one component in the ongoing evaluation of funding.

The investment rate of return is just one of many assumptions used in funding the plans. Although it undoubtedly has one of the largest impacts, it is important to evaluate it relative to the other assumptions (i.e. wage inflation, price inflation, retirement rates, mortality, etc.). That's why one of the relationships we and the actuaries focus on is referred to as the spread, which represents the excess investment return over price inflation. As you may know, our five-year experience study (ORC Section 145.22) considers collectively *all* of those assumptions. We do these analyses regularly and adhere to a disciplined approach. OPERS just completed an experience study in 2016, which represented the period of 2011 to 2015. One of the results of this study was to reduce our investment return assumption to 7.5%.

It is also important to understand that not all systems are the same, though most reports often fail to acknowledge that. As we analyze our actuarial accrued liability and more of that liability is related to non-active members, the nominal investment return rather than the real investment return assumption becomes a more prominent factor. Thus, one of the components of the experience study is to analyze the comparative data base of forward-looking investment consultants' expected nominal rates of return and break that down into the components of each investment consultant's inflation assumption and real expected rate of return. Since investment consultants' inflation assumptions vary from consultant to consultant, this normalization allows us to derive the range of expected real rates of return and use that in conjunction with our inflation assumption. We also analyze the expected standard deviation of the expected return and especially focus on the 40th, 50th and 60th percentiles in establishing our investment return assumption. We also analyze the probability of exceeding our recommended investment rate of return.

Bond rating agencies use the liability data for other purposes, including assigning risk of default on debt issuance. As you know from our work with your office on the GASB pension changes, the GASB, after extensive review, determined the development of the assumed investment return assumption was best left to the individual system. The GASB did, however, develop safeguards to ensure it was reasonable. Despite the GASB's new pronouncement and extensive changes, many bond issuers have elected to "re-value" pension system liabilities based on their own judgement using a broad standard assumption and not taking into account pension plan specifics as the GASB had recognized was important. This "re-valuing" of the liabilities often results in a significant overstatement of the liabilities. OPERS responded to Moody's solicitation of feedback and we engage in regular calls with

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the three major bond issuers to update them on OPERS' financial condition on behalf of all our 3,700 employers. Our state is a prime example of the impact of bond issuers' use of general assumptions. Since Ohio's contribution rates are statutorily established and will not increase or decrease based on the funding, funding issues are addressed through plan design changes rather than contribution increases.

We understand that none of us can predict the future of investment returns; however, we have collected a team of highly-skilled professionals and consultants to balance our risk through reasonable asset allocations. Rest assured, we are constantly monitoring our results relative to our assumptions. Our actuaries are required by their actuarial standards of practice that the economic assumptions be individually reasonable and consistent with one another. No one takes this responsibility more seriously than the OPERS staff, Board and actuaries.

I hope this helps to provide more information relative to your concerns. We appreciate the partnership with your office on the GASB work and would be happy to discuss with you in further detail at any time.

Thanks again, for your interest.

Respectfully,

Karen E. Carraher

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