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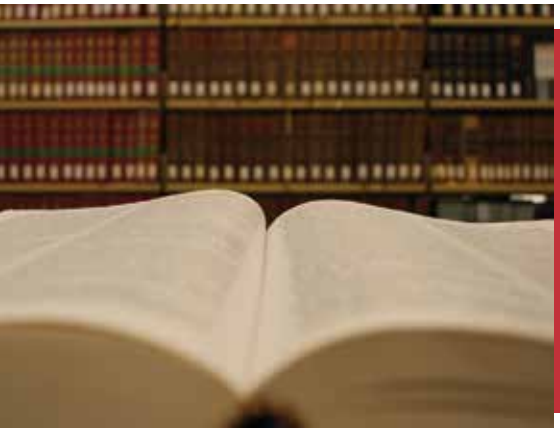

Applying Fiduciary Principles to Setting Investment Return Assumptions

By Carolyn Welch Clifford
Ottosen Britz Kelly Cooper Gilbert & DiNolfo, Ltd.

How DOI's new experience study will affect firefighter and police pension funds?

When the Illinois General Assembly enacted fundamental changes in 2011 to the way Illinois firefighter and police pension funds should be funded with the addition of the projected unit credit actuarial cost method and 90% funding target, it was the first significant change to funding policy in nearly 20 years. Now, six years after "statutory minimum funding" entered the lexicon of the Illinois public pension domain, the Illinois Department of Insurance (DOI) has taken steps to change its approach to preparing its actuarial valuations for firefighter and police pension funds.

In October of 2017 Gabriel, Roeder, Smith & Company (GRS), the newly engaged actuarial firm for the DOI, issued its "2017 Actuarial Assumptions Review for Fund Fiscal Years 2011 through 2016." The document provides insight into the actuarial assumptions GRS will use to perform the annual actuarial valuations on behalf of pensions funds covered by Articles 3 and 4 of the Illinois Pension Code. As explained in its transmittal letter to the DOI, GRS stated:

> The primary purpose of this review is to examine the continued appropriateness of the key actuarial assumptions by comparing actual experience to expected experience. Our study was based on census information for fund fiscal years ending in 2011 through fund fiscal years ending in 2016, as provided by the Department of Insurance.

The review covered the gamut of key actuarial assumptions, including total payroll growth, salary increases, retirement and disability, as well as mortality. But perhaps most significant in this review are the updates to the investment return assumptions in the DOI actuarial valuations.

Changes to Investment Return Assumptions

In its assumptions review, GRS explained that the specific asset allocation adopted by each Article 3 and 4 fund -- within the limited universe of investment options under the Illinois Pension Code -- will have a significant impact on the overall performance (investment return) of the fund. To determine how the investment return assumption should be set for each "category" of pension fund based on size of assets (*see Table 1*), GRS reviewed capital market assumptions developed and

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Table 1 – Investment Return Assumption by Category

Category of Fund	Size of Fund by Assets	Unadjusted Investment Return Rate	Probability of Achieving Rate	Previous Return Assumption	Final GRS Return Assumption
1	Funds with net assets of less than $2.5 million	4.0%	49.07%	5.0%	5.0%
2	Funds with net assets of between $2.5 million and $4,999,999 million	5.5%	43.15%	6.0%	5.75%
3	Funds with net assets of between $5 million and $9,999,999	6.0%	40.69%	6.5%	6.25%
4	Funds with net assets of $10 million or higher	6.5%	43.84%	6.75%	6.5%

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published by 10 independent investment consulting firms, with varying time horizons.

Using target asset allocations for each category of fund, GRS calculated the range of long-term net returns that could be expected to be produced by the four different investment portfolios it developed for each category of funds. The probability of earning the various investment returns for each of the four categories of Article 3 and 4 pension funds is set forth in Table 1.

GRS stated that an investment return assumption ranging from 5% to 6.5% could be supported *if a fund is at least marginally funded (i.e. 50%) and maintains a reasonable ratio of assets to benefit payments (liquidity ratio).* As GRS analyzed the data of the Article 3 and 4 pension funds, it determined a number of funds had low funded ratios and/or low liquidity ratios. GRS explained:

For example, there are 37 plans with assets of more than $10 million (Category 4) with either a funded ratio less than 40 percent and/or a liquidity ratio less than 8. *It will be very difficult to support a 6.5 percent investment return assumption for these plans.* Similar situations exist for Category 1, 2 and 3 plans. [emphasis added]

GRS is concerned that some pension funds might not be able to achieve the expected returns. As a result, GRS included an additional step in setting the investment return assumption for each Article 3 and 4 pension fund, which is an evaluation of two factors:

- The funded ratio of the pension fund (assets divided by accrued liabilities)
- The liquidity ratio of the pension fund (assets as divided by expected benefit payments)

For pension funds with funded ratios below 40%, GRS lowers the investment return assumption used in the actuarial valuation by 25 basis points. In addition, GRS recognizes additional reductions in the investment return assumptions for funds with funded ratios below 30% and below 15%, as well as based on low liquidity ratios. In short, Article 3 and 4 pension funds with a low funding status and cash flow concerns will see more conservative investment returns assumptions used in their DOI valuations, ranging anywhere from 6.25% to 5%.

Table 2 – Impact of new DOI actuarial assumptions

Sample Police Pension Fund	Sample Firefighters' Pension Fund
Actuarial liabilities increased by 8.5%	Actuarial liabilities increased by 6.6%
Total normal costs increased by 6.9%	Total normal costs increased by 3.6%
Employer's actuarially determined contribution increased by 21.7%	**Employer's actuarially determined contribution increased by 16.2%**

Impact of the new DOI actuarial assumptions

GRS estimated the potential cost impact of the assumption changes by reviewing two sample plans, one police fund and one firefighter fund. In both sample funds, the discount rate was changed from 6.75% to 6.5%. **Table 2** shows the cost impact GRS determined from these sample plans. It is important to understand that changes to actuarial assumptions – particularly the investment return assumption – affect both employer's contribution but also the liabilities side of the equation.

As a result of these new assumptions, pension funds may need to become more conservative in setting investment return assumptions in their own valuations. Specifically, the lower investment return assumptions by DOI signal the expectation that funds with lower funded percentages and cash flow concerns will have increasing difficulty in achieving investment returns compared to their better-funded peer funds.

As with DOI's prior actuarial firm, GRS continues the practice of footnoting its actuarial valuations to state its disapproval of the statutory minimum funding approach. Specifically, the DOI actuarial valuations report states:

This report should not be relied upon for purposes other than determining the current tax levy required under the Illinois Pension Code. The assumptions have been set based on expectations for all Article 4 funds in the State of Illinois. The actuarial methods are prescribed by the Illinois Pension Code *and do not necessarily represent the approach recommended by either the actuary or the Department of Insurance.* [emphasis added]

In its "Actuarial Valuation Report Disclosures Document," GRS states:

Please understand, however, that *contributing the Actuarially Determined Employer Contributions shown on page 2 of the Actuarial Valuation Report does not necessarily guarantee benefit security*, primarily because the goal of the funding policy is only to reach 90% funding rather than 100% funding by the end of municipal fiscal year 2040. In order to attain 100% funding (as opposed to the 90% requirement in the Illinois Pension Code), *we encourage you to consider an annual contribution that is greater than the Actuarially Determined Employer Contributions shown* on page 2 of the Actuarial Valuation Report for your Fund. [emphasis added]

Where fiduciary duties intersect with investment return assumptions

The investment return assumption in an actuarial valuation is a significant cost driver in determining annual employer contributions. In setting the investment return assumption, actuaries look to investment professionals to give their best educated guess at future investment returns in the long term (30 to 40 years for most plans) and evaluate those projections in conjunction with the pension fund's asset allocation.

When setting an investment return assumption, pension trustees often ask, "Are we setting our investment return assumption to match the return expected from the asset mix, or are we setting our

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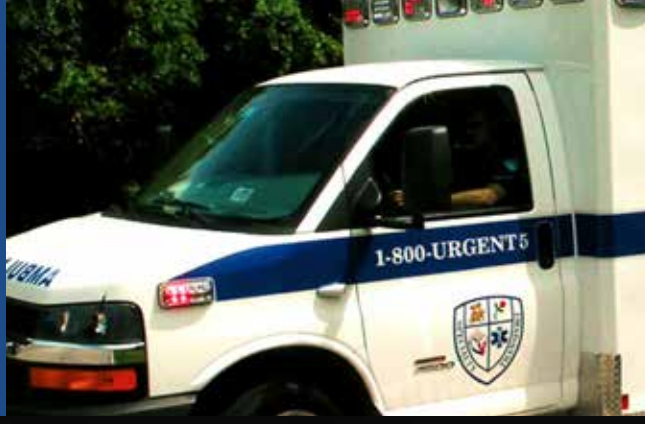

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asset allocation to chase an investment return assumption?" As fiduciaries with a responsibility to be prudent experts in administering the plan, pension trustees must exercise a **duty of care** in making and monitoring investments for the fund. This, in turn, should drive the investment return assumption used in the annual actuarial valuation.

An additional fundamental principle of fiduciary duty is the **duty of prudence**, which requires fiduciaries to consult with experts in making decisions for the plan. Thus, when the fund's investment professional gives advice on investments, trustees should follow that advice unless they can demonstrate an informed, reasonable, and prudent rationale for failing to do so. Similarly, trustees should rely upon professional actuaries for expert advice on setting appropriate actuarial assumptions for the annual valuation. With that said, prudent fiduciaries should question methods and assumptions that do not make sense.

Public pension plans are under increasing pressure to lower their investment return assumptions. However, when investment return assumptions are lowered, the annual employer contribution will increase. Municipal contributions must increase because the assumed investment return is lower (easy to understand) and the liabilities are greater due to the lower discount rate (not as easy to understand). This creates a dilemma for trustees who are cognizant of the impact higher employer contributions will have on the municipal entity. This raises another fundamental principle of fiduciary duty: the **duty of loyalty**.

The duty of loyalty requires that a fiduciary administer the fund solely in the interest of the beneficiaries of the fund. It is not the responsibility of the pension trustee to consider the impact on the employer of a decision that is in the best interest of the fund; rather, the duty of loyalty dictates that the decision must be made strictly based on what furthers the fund's purpose.

Pension fund trustees, however, do not live in a vacuum; the impact of reducing investment return assumptions will often be felt directly by trustees when they put on their competing "hat" as firefighter, finance director, police chief, or taxpaying citizen of the municipality. Nevertheless, a fiduciary is not permitted to "administer" the pension fund for another party (such as a union or municipality), even if the trustee has been appointed or elected by that interested party. Remembering to put on the "pension hat" when weighing these decisions is critical in the role of fiduciary for a pension fund.

***About the Author**: **Carolyn Welch Clifford** is a partner with Ottosen Britz Kelly Cooper Gilbert & DiNolfo, Ltd. in Naperville, Illinois. Ms. Clifford earned her B.S. and J.D. degrees from the University of Illinois in Urbana-Champaign. She serves as editor of one of the firm's publications, Legal Insights for Pension Boards, and is a frequent speaker at fire service and public pension conferences in Illinois and nationally. Ms. Clifford currently serves as chair of the Public Safety Affinity Group of the National Association of Public Pension Funds. She concentrates her practice in the representation of Illinois firefighter and police pension funds, as well as fire and police commissions and fire protection districts. You can contact her at cclifford@ottosenbritz.com.*

The Takeaways

In setting the investment return assumption, the fiduciaries of the pension fund should review and consider:

- The advice of their professional experts: the fund's investment professional, actuary and legal counsel.
- Data generated by modeling provided by the fund's investment professional and actuary.
- Various applicable studies and data, including historic (as well as more recent) stock market and interest rate trends, and comparative data from other public-sector pension plans.
- The pension board's risk tolerance.
- Specific legal limitations, such as applicable State law, and the DOI's current investment return assumption applicable to the fund.
- The current pension fund asset allocation, risk premium, and alpha.
- Economic data, including inflation and GDP (productivity).

To ensure the process used to determine and set the investment return assumption aligns with their fiduciary responsibility, trustees should:

- Make sure the process is well documented.
- Adopt the process as a recurring practice at appropriate intervals.
- Design the process to comply with the board's responsibility to act as a prudent expert and loyal trustee with respect to this aspect of fund administration.

In short, the investment return assumption should be reasonably set to require contributions into the plan that will maintain the integrity and competency of the fund's assets to timely pay all promised benefits to the beneficiaries of the plan. With the assistance of its actuary, the board should review the impact of its decision upon the actuarial valuation results relating to the amortization period to achieve 100% funding status. Moreover, as the fund matures, the board should measure the ratio of the assets to the benefit payments, to insure proper cash flow.

While the decision to adjust actuarial assumptions that drive higher employer contributions can be complicated by pressures from outside interests, pension trustees cannot ultimately control the decisions of their municipalities to annually meet recommended annual contributions. However, when boards work with their professionals to engage in a thoughtful and well-document process to prepare the actuarial valuation, trustees can be assured that they have taken the necessary steps to fulfill their fiduciary obligations to the fund's membership to safeguard the integrity of the plan to make benefit payments in the future. ■