MINUTES
ARKANSAS TEACHER RETIREMENT SYSTEM
BOARD OF TRUSTEES-CALLED TELEPHONIC

Monday, December 17, 2018
3:45 p.m.
1400 West Third Street
Little Rock, AR 72201

ATTENDEES

<u>Board Members Present</u>
Jeff Stubblefield, Chair*
Danny Knight, Vice Chair*
Dr. Richard Abernathy*
Lloyd Black*
Kelly Davis*
Bobby G. Lester*
Robin Nichols*
Deborah Thompson*
Janet Watson*
Susannah Marshall, designee for Candace Franks*
Johnny Key, Ed. Commissioner*
Honorable Andrea Lea, State Auditor*

<u>Board Members Absent</u>
Anita Bell
Kathy Clayton
Hon. Dennis Milligan

<u>ATRS Staff Present</u>
Clint Rhoden, Executive Director
Rod Graves, Deputy Director
Laura Gilson, General Counsel
Willie Kincaid, Director of Operations
Manju, Director, Information System
Jerry Meyer, Manager, Real Assets
Tammy Porter, Executive Assistant
Leslie Ward, Manager, Private Equity

<u>Guest Present</u>
Sean Barron, Simmons Bank
PJ Kelly, AHIC*
Katie Comstock, AHIC*

<u>Reporters Present</u>
Mike Wickline, AR DemGaz

via telephone

I. **Call to Order/Roll Call.** Mr. Jeff Stubblefield, Chair, called the Board of Trustee meeting to order at 4:00 p.m. Voice roll call was taken. Ms. Bell, Ms. Clayton and Hon. Milligan were absent.

II. **Adoption of Agenda**

> **Ms. Nichols *moved* for *adoption* of the Agenda. Danny Knight s*econded* the *motion,* and the Board *unanimously approved the motion.***

III. Executive Summary. The Executive Summary was provided for reference with no questions or expansions on the written summary.

IV. Potential 2019 Legislation.

A. Noncontributory Designation to Simplify Process for Employers, Members and ATRS. Director Rhoden discussed with Noncontributory designation to simplify the process for employers, members, and ATRS. Back in 1987, the noncontributory option was created to allow members with lower salaries to elect exemption from making contributions in exchange for a lower multiplier being used in their benefit formula when they retire. Generally, members are only allowed to choose the noncontributory option if they are part-time or working under contract for 180 days or less. Basing noncontributory eligibility on employment contracts is troublesome since ATRS does not have access to a member's actual contract. However, salary information is required to be reported to ATRS for each member. Basing noncontributory eligibility on member salary would maintain the original intent of the 1987 noncontributory law and be more efficient for ATRS.

Potential legislation has been drafted for determining noncontributory eligibility for new members. A new member's projected salary as reported by the employer would be used to set the initial contribution status. As long as this member's annual reported salary remained below the noncontributory salary threshold set by the Board they could remain as a noncontributory member. Once the member's annual reported salary exceeds the noncontributory salary threshold they would automatically be set to contributory status the following fiscal year. This legislation would also protect the noncontributory status of current members and in no way prevents noncontributory members from electing to become contributory members.

Board members had discussions on the amount to set the salary threshold. Executive Director Clint Rhoden told the Board he would do whatever the Board wanted to be done.

> **Ms. Davis *moved* to set the salary threshold for Noncontributory members at $18,000. Mr. Abernathy *seconded* the *motion*, and the Board *unanimously* approved the *motion.***

V. Investment Committee Report. *Robin Nichols, Chair*

A. Recommendation to Commit up to $74.5 Million Dollars for an Expected Revenue Stream of $100 Million Dollars of State of Arkansas Recycling Tax Credits to be Paid by the State of Arkansas with Imminent Need.

Rod Graves, Deputy Director, gave the report on this recommendation. He stated that this is very similar to the item the Board approved in 2016. This has to do with the expansion of the BRS project in Osceola, Arkansas. Similar to the transaction the Investment Committee and the Board approved in 2016. This proposal is in 2 parts. The first part would be essentially the $74.5 million dollars would be a loan for approximately 2 years. During which time ATRS would charge an interest rate of 7.75% on the purchase price of the revenue stream beginning on the funding date of this proposal and continuing until the recycling tax credits for this phase are certified by the Arkansas Department of Environmental Quality (ADEQ). The expected period of time between the funding date and the certification of the recycling tax credits by ADEQ is two years. The PIK interest rate is intended to compensate ATRS for any risks associated with the period of time between the funding date and the date of recycling tax credit certification. After the completion of the certification process, the accumulated PIK interest would be treated as a loan to BRS to be paid within 5 years with the interest rate for the PIK interest loan increasing each year until the loan is paid. Once the certification process is complete, the risk in this fixed income proposal is essentially a state of Arkansas payment risk like an Arkansas general obligation (GO) bond. If this proposal is recommended by the ATRS Investment Committee and approved by the ATRS Board, the expected funding date of the transaction would be near the end of 2018.

The amount of recycling tax credits to be issued to BRS is expected to be $125 million dollars. The final true up of the recycling tax credits is expected to be certified by ADEQ in early 2021. The recycling tax credit is set at 30% of equipment purchases and installation costs at a recycling facility, such as BRS. ATRS and BRS are estimating the total amount of certified tax credits to be issued for phase II of BRS to be $125 million dollars. The planned expansion may generate more than the expected $125 million dollars in recycling tax credits but ATRS staff and BRS limit the proposed transaction to just the first $125 million dollars in recycling tax credits, in any event.

Act 862 of 2015 (Act 862) is related to phase I of BRS and requires the state of Arkansas to purchase phase I BRS recycling tax credits for 80% of the face value. Act 862 sets a maximum tax credit submission per year of $20 million dollars and established the current annual state of Arkansas payment for the phase I tax credits of $16 million dollars that should last for 14 to 15 years. Act 1046 of 2017 (Act 1046) relates to the expansion of recycling related projects and is similar to Act 862 but limits the annual maximum tax credit submission to $11 million dollars. Since the phase II recycling tax credits are related to the expansion of BRS, the $11 million dollar cap applies to this tranche of the recycling tax credits.

As part of the economic incentives provided by the state of Arkansas, BRS is entitled to receive recycling tax credits in the expected amount of $125 million dollars issued by the state of Arkansas. Arkansas law now puts ATRS in possession and control of these tax credits on behalf of BRS. ATRS has obtained and sold state of Arkansas issued tax credits in the past, including a similar transaction for prior BRS related tax credits. Here, the state of Arkansas, itself, has committed by law to purchase the tax credits to save the state $2.2 million dollars a year. The state saves $2.2 million dollars by paying $8.8 million dollars for $11 million dollars of tax credits to cancel the tax credits, instead of having $11 million dollars in reduction of state revenue by the tax credits being claimed on tax returns.

Using just above a 5% discount rate (interest rate) the current value of the expected income stream is approximately $74.4 million dollars but may be as high as $74.5 million dollars. ATRS would immediately receive a set up fee of **$800,000** paid by BRS to make the net cost for the tax credits around $73.6 million dollars. After the certification process is complete the revenue stream would consist of annual $8.8 million dollar payments (80% of the $11 million dollar cap) for 11 years and a final payment in year 12 of $3.2 million dollars (80% of the remaining $4 million dollars of recycling tax credits), totaling $100 million dollars over 12 years.

The ATRS consultant on this investment, Simmons Bank, and ATRS staff recommend ATRS commit to purchase the expected $125 million dollars in recycling tax credits that should generate a revenue stream of $100 million dollars over 12 years for approximately $74.5 million dollars. This proposal is one that allows ATRS to maintain stronger fixed income returns with a focus on Arkansas investments while reducing nongovernmental risk. Since the only close for this investment opportunity is expected to take place before the next scheduled meeting of the ALC, Imminent Need is being requested.

Mr. Graves stated that as a 20% equity owner of BRS, at a certain point ATRS will get the benefit of 20% of the purchase price through return of capital or additional equity. Mr. Graves confirmed that staff concurs with the recommendation.

a. Resolution 2018-40.

Ms. Nichols *moved* to *adopt* Resolution 2018-40, to Commit up to $74.5 Million Dollars for an Expected Revenue Stream of $100 Million Dollars of State of Arkansas Recycling Tax Credits to be Paid by the State of Arkansas with Imminent Need. The Board *unanimously adopted* the *Resolution*.

B. Recommendation to Commit up to an Additional $70 Million Dollars in Aeolus Catastrophe Keystone PF Fund, LP, an Opportunistic/Alternative Reinsurance Fund Specializing in Property Catastrophe Insurance Coverage with Imminent Need. This is the fourth recommendation on investing with Aeolus, after a recommendation of up to $110 million dollars was approved in 2015, a recommendation of up to $37 million dollars was approved in 2016, and a recommendation of up to $110 million dollars in 2017.

Aeolus Reinsurance, based in Bermuda, was founded in 2006 by Peter Appel and David Eklund. This firm was seeded by large investors, such as Bank of America and Merrill Lynch, and successfully provided global catastrophic protection to the reinsurance market for several years. In 2011 the founders transformed the firm into Aeolus Capital Management in order to raise capital from other third party investors to provide additional flexibility in deploying capital. The fund, Aeolus Property Catastrophe Keystone PF Fund, LP, seeks to use highly customized portfolios based on actuarial projections concerning catastrophic events, such as hurricanes, to provide returns that are not usually correlated to other asset classes. The fund is expected to yield a gross return of the Treasury bill rate plus 15%, or 10-11% net of expected losses and fees. Reinsurance and retrocession markets underwrite in two seasons, January 1st and June 1st.

The Board authorized commitment of up to $110 million dollars in the fund at the October 5, 2015 meeting was for the January underwriting season. The Board authorized commitment of up to $37 million dollars in the fund at the April 4, 2016 meeting was for the June underwriting season. The Board authorized commitment of up to $110 million dollars at the November 13, 2017 meeting was split with $50 million dollars added to the January 2018 underwriting season and $60 million dollars made available to cover larger than normal holdbacks across the prior tranches to maintain the appropriate ATRS investment allocation to each tranche.

Both Aon Hewitt Investment Consulting and ATRS staff recommend an additional allocation of up to $70 million dollars to Aeolus Property Catastrophe Keystone PF Fund, LP. The expected distribution of the additional allocation is approximately $26 million dollars added to the January 2019 renewal tranche with the estimated remaining $44 million dollars to be available for the June 2019 or other future renewals. Because of hurricanes during the recent underwriting seasons, Aeolus is reserving more funds than usual to deal with any potential claims. The $70 million dollar additional commitment is needed this year for two reasons. The first reason is to take advantage of the current opportunity for increased expected returns. The premiums that create profits for Aeolus are expected to increase from 10% to 30% due to claims created by the recent hurricanes. The second reason is the higher than usual level of claims creates a need to reserve additional funds that would normally be released to investors in time for investment in the upcoming January tranche. The additional allocation for January 2019 ($26 million dollars) will be used to maintain the recommended ATRS renewal amount in the January 2019 tranche to take advantage of the upcoming underwriting season that is expected to be well positioned to gain from the increasing premiums. The remaining allocation request of $44 million dollars is intended to deal with the timing issue between reserves for potential claims, and the timing required to fund other upcoming underwriting seasons. Similar to the prior investments in Aeolus, the draft resolution for this additional allocation also allows for recallable distributions.

If approved, ATRS will add to the current commitment to the January renewal term to reach the recommended allocation for this renewal period. Investment in reinsurance funds will help ATRS to continue to add diversification to the ATRS portfolio and help reduce the reliance on the traditional stock and bond markets. Since the only close for this investment opportunity is expected to take place before the next scheduled meeting of the ALC, Imminent Need is being requested.

Mr. Graves stated staff concurs with the recommendation.

a. Resolution 2018-41.

Ms. Nichols *moved* to *adopt* Resolution 2018-41, to Commit up to an Additional $70 Million Dollars in Aeolus Catastrophe Keystone PF Fund, LP, an Opportunistic/Alternative Reinsurance Fund Specializing in Property Catastrophe Insurance Coverage with Imminent Need. The Board *unanimously adopted* the *Resolution*.

V. Adjourn.

Mr. Lester moved to *adjourn* the Board Meeting. Mr. Black *seconded* the *motion*, and the Board *unanimously approved the motion.*

Meeting adjourned at 4:26 p.m.

Clint Rhoden Executive Director	Mr. Jeff Stubblefield, Chair Board of Trustees
Tammy Porter, Recorder	Date Approved