South Dakota Legislative Research Council

MINUTES
Retirement Laws Committee

First Meeting
2009 Interim
June 4, 2009

View 34
Lower Level Conference Room
Pierre, South Dakota

<u>Thursday, June 4, 2009</u>

The first meeting of the Retirement Laws Committee was called to order by Chair, Representative Tim Rounds, at 9:00 a.m. (CDT) at the View 34 Lower Lever Conference Room, Pierre, South Dakota. The meeting was held jointly with the South Dakota Retirement System Board of Trustees.

The meeting was held with the following members present: Senators Corey Brown, Sandy Jerstad, and Tom Nelson (Vice Chair); and Representatives Marc Feinstein, Noel Hamiel, Patrick Kirschman, Tim Rounds (Chair), and Manny Steele. Senators Gene Abdallah and Kathy Miles were excused.

Staff members present included Annie Mehlhaff, Principal Fiscal Analyst, and Lisa Shafer, Legislative Secretary.

(NOTE: For purpose of continuity, the following minutes are not necessarily in chronological order. Also, all referenced documents distributed at the meeting are attached to the original minutes on file in the Legislative Research Council (LRC)).

SDRS Trustee Member Election Results

Ms. Dawn Smith, Executive Assistant for the South Dakota Retirement System (SDRS), distributed to the committee the "2009 Election – Canvassers' Report." (**Document #1**) She stated that there were five open positions, and four of the five positions were filled with current members. The new board member is Steve Caron from Aberdeen.

Update of SDRS FY2009 Investment Performance

Mr. Matt Clark, State Investment Officer, informed the committee that as of May 31, 2009, the investment performance is negative 19.5% which is up from a negative 23% at the end of April. The return in February was estimated to be around negative 35%, but with the slight recovery in the markets, the investment performance was higher than previously anticipated.

In response to a question posed by **Mr. Jason Dilges**, Commissioner of the Bureau of Finance and Management, Mr. Clark said that the investment performance of negative 19.5% is consistently in-line with the benchmarks. This is due to the unusually big performance in global equity and the amount in real estate that is market sensitive.

Preliminary Considerations of Potential Corrective Actions

A handout entitled "SDRS Board of Trustees Consideration of Possible Recommended Corrective Actions" (**Document #2**) was distributed to the committee.

Mr. Rob Wylie, Executive Director/Administrator for SDRS, said that SDRS has a fantastic funding policy. It may be the only one in the United States that is this complete and diverse. Defining objectives, establishing a process for benefits improvements, and making statutory conditions for mandatory adjustments are unique to South Dakota.

Mr. Paul Schrader, Consultant, informed the members that it is the responsibility of SDRS to make policy recommendations to maintain the validity of the system. The Board will review the thresholds and triggers to refine them and be more precise as to when recommendations are necessary.

Throughout the history of SDRS, the market value funded ratio generally always exceeds the actual value funded ratio. A similar market decline occurred in the early 2000s. At that time, the market value funded ratio was under 100%, but it quickly recovered. The money in the reserves enabled the system to be maintained throughout the decline.

Compared to the peer groups, SDRS is about 36% better funded than the average funded ratio with similar measure dates. Mr. Schrader said that SDRS is among the top 10 in the United States.

There is a very long-term horizon for measuring performance and success for SDRS. Even with the drop in markets, there will not be an inability to pay benefits. However, there are long-term issues if there is no recovery in the market. A drop below the actual value of 7¾% creates a deficit. The deficit requires an additional investment return in the future to make-up the difference.

Mr. Wade Hubbard, SDRS General Counsel, provided an overview of the legal issues surrounding any potential corrective actions. According to the US Constitution, Article 1, Section 10 and the South Dakota Constitution, Article VI, Section 12, if a state amends its law to decrease benefits granted under its public employee retirement system, it impairs an obligation arising under the members' employment contracts, and thus violates the federal and state constitutions. Most states regard a relationship to be between the public employer and the employee. If the employer amends the laws and changes the contract with the employee, the employer may be in violation of the constitution. Based on the South Dakota Supreme Court case of *Tait v. Freeman*, the South Dakota Supreme Court states that SDRS benefits are part of the public employment contract. Any significant change in the contract can be challenged under the US and state constitution. Mr. Hubbard explained two legal cases from which the state would be allowed to make changes based on economic times and conditions.

Mr. Hubbard concluded that:

- If a case were to go to its Supreme Court, South Dakota likely would remain a "contract state;"
- Absent special circumstances, the federal and state constitutions would not allow amendment of public employees' contracts, including changes;
- If the South Dakota Supreme Court found that economic circumstances were severe enough, it very well could approve reasonable changes to SDRS benefits; and
- The benefit improvements made in 2008 are safe to reduce, legally speaking.

The committee recessed at 10:22 a.m. and reconvened at 10:38 a.m.

SDCL 3-12-122 contains specific conditions that mandate immediate reporting to the Governor and the Retirement Laws Committee and recommend corrective action if the conditions exist for three consecutive years. The existence of any of the following conditions triggers action:

1. The contributions do not equal actuarial requirement for funding;
2. The funded ratio based on market or actuarial value of assets is less than 80%; and/or
3. The market value of assets is less than 90% of the actuarial value.

The third condition will be the first to apply and will likely exist if the market return for FY09 is worse than negative 10%. Mr. Hubbard said that it will be prudent to establish preferred potential actions before the statutory requirements take effect.

Mr. Doug Fiddler, Consulting Actuary for Buck Consultants, told the committee that the projected funded status for the FY2009 investment return is negative 16.59%. With this loss, the third trigger would be met, and corrective action would be required. If the investment return is negative 20% or worse, then all three triggers would be met. At that time, the actual value of assets would be adjusted to stay within the corridor for market values. The differences in projected required investment return based on whether correction action was taken are displayed on pages 16 and 17 of document #2.

Mr. Paul Schrader discussed the current activity by similar systems. He said that other systems have stated concern for the situation, but very little action has been taken. The most common remedies discussed have been higher employer contribution, new benefit tier, and modification to actuarial methods to reduce or delay impact.

Mr. Schrader informed the members that the Board of Trustees is committed to maintain both the long-term financial integrity of SDRS and the current earned benefits. However, limited corrective action may be advisable and recommended for the next legislative session. Preliminary SDRS recommendations are listed on pages 19 and 20 of Document #2.

In response to Senator Brown’s question, Mr. Schrader said that $350 million in present value is the critical point to initiate change.

Mr. Schrader stated, in response to Representative Tim Rounds’ question, that there have been 26 rolling ten-year periods. Of those 26, 24 of them have had a return of over 10%.

Retirees Returning to Work

Mr. Wylie told the committee that this topic is complex and SDRS is trying to create ideas that fit into the structure. When a person retires and fully terminates employment, he/she will begin to receive benefits. If the person returns to public work, he/she would be able to participate in SDRS again. SDRS needs to determine if it was a bona fide termination of employment and if there is a full break in service.

Mr. Fiddler distributed a handout entitled “South Dakota Retirement System Return to Work Provisions”. (**Document #3**) He noted that an overall cost estimate for the people that have returned to work was provided at the last meeting. Without the changes made in 2004, the cost to SDRS would be four-times higher. The changes have eliminated most of the cost, but there is still residual cost.

SDRS is not a party to the decision to reemploy a retiree. It is a decision between the employer and the employee. However, SDRS should not be financially harmed if a retiree returns to work.

Based on the return to work provisions that were effective July 1, 2004, Mr. Fiddler stated that the most recent analysis showed that:

- 11% of all retirees have returned to work;
- 76% of members returning to work have returned within six months;
- About 75% of reemployed members have returned to the same employer;
- Most rehires return to work for more than three years;
- The provisions are predominately being used by members who would not have retired without them;
- Members are retiring earlier than expected;
- Reemployed members are working long enough to earn a second vested benefit;
- About two-thirds of the added cost have been eliminated with the 2004 changes; and
- SDRS has incurred an average annual cost of approximately $5 million since 2004 due to retire/rehire.

In response to **Judge Steve Zinter's** question, Mr. Fiddler said that the additional cost to SDRS is incurred because there is less time for SDRS to fund the benefit. Typically after a person retires, the position is filled with a younger person. The younger person will need to work longer before retirement thus allowing SDRS more time to gain compounded interest to fund the benefits.

Senator Brown asked if there is a particular entity where the retire and rehire process occurs more often. Mr. Wylie said that approximately 2% are school employees, 2.7% are teachers, 2.6% are state employees, 1.1% are municipalities, and 1.9% are counties. The judicial branch has no rehires and the Board of Regents has less than 1% rehired.

In response to committee discussion, Mr. Fiddler stated that there is an average of a 13% increase for members that retire and return to work. This equals about $5 million per year.

The current SDRS provisions provide an increase in the value of a member's total compensation. Additional steps may be required to protect the system from the potential abuse of members receiving retirement benefits without a bona fide termination.

Mr. Fiddler discussed the pros and cons of four potential action steps which are outlined on pages 6 – 9 in document #3. The potential action steps are:

1. Make no changes;
2. Modify the amount and duration of benefits paid to make provisions cost-neutral;
3. Require a period of separation before reemployment if benefits are to continue (6 – 12 months); and
4. Suspend all benefits upon reemployment.

The committee discussed the primary concern with the return to work provision – cost, philosophical, or equity. Some of the issues mentioned included not limiting rural schools to hire teachers, legal ramifications, double-dipping, and the "Rule of 85."

Mr. Elmer Brinkman, Board of Trustees President, said that there needs to be some understanding on the part of the public for the people that work in public service Class B and return to work in Class A. The work requirements for those people are different and therefore there are some special benefits for those employees.

CEM 2008 Report

Ms. Jan Hartford, Director for CEM Benchmarking Inc., presented the “South Dakota Retirement System Pension Administration Benchmarking Results for FY 2008”. (**Document #4**) She informed the committee that the report is a management tool to help determine if the system is providing cost-effective services.

There are sixty-nine leading global pension systems participating in the benchmarking service. The systems are located in the United States, Canada, the Netherlands, Europe, and Australia. The peer group – US participants closest to SDRS in size – is listed on page 4 of Document #4.
Some of the results listed in the CEM report include:

- The total adjusted administrative cost is $2,754 million;
- SDRS cost per active member and annuitant was $48, which is lower than the peer median of $76;
- SDRS cost trends have increased 1.4% per annum compared to an increase of 2.2% for the average 4-year participant;

Ms. Hartford listed five factors that impact cost. They are transaction volumes, economies of scale, cost environment, complexity, and service levels.

- Transaction volumes include the number of telephone calls, the number of pensions incepted, and the number of one-on-one counseling sessions. SDRS transaction volume is close to the median of the peer group. Ms. Hartford noted that SDRS had about 700 more calls, emails, and letters for every 1,000 active member and annuitant.
- The economy of scale for SDRS is 57,265 compared to a peer median of 90,445.
- SDRS cost environment is 20.3% lower than the peer median.
- SDRS scored close to the peer average in the four highest weighted causes of complexity (pension payment options, customization, plan type, and multiple benefit formula).
- The total service score for SDRS was 79; which is above the peer median of 76. Ms. Hartford noted that SDRS scored well in most critical areas and that it would not be cost effective to have a service score of 100.
- SDRS had a Customer Relations Membership (CRM) score of 83 compared to the peer median score of 72.

In March and April, the biggest pension administration issue reported to CEM from all countries was market conditions.

Ms. Hartford noted that the Danish have a cost of $8 per member because they are paperless.

In response to **Representative Marc Feinstein’s** question pertaining to computer literacy, Ms. Hartford stated that this issue is a problem; however, it is changing. Mr. Wylie commented that the number of retirees having access to computers is increasing.

Mr. Wylie distributed to the committee the “SDRS Customer Service Member Satisfaction Surveys” (**Document #5**) for the members to review. He noted that every comment received is distributed to the staff, and the information helps to enhance the services provided.

Administrator's Compensation

Mr. Brinkman stated that due to the current economic situation, it is in the best interest of SDRS not to increase the administrator's salary. This fiscal year his position has been treated similarly to all regular employees. Mr. Brinkman hopes to discuss the issue at a later date if economic conditions improve.

Adjourn

REPRESENTATIVE STEELE MOVED, SECONDED BY REPRESENTATIVE FEINSTEIN, THAT THE COMMITTEE ADJOURN. The motion passed unanimously by a voice vote.

The meeting adjourned at 12:41 p.m.