South Dakota Legislative Research Council

RETIREMENT LAWS COMMITTEE MINUTES

Second Meeting
2003 Interim
December 10, 2003

Ramkota Inn
Pierre, South Dakota

The second meeting of the 2003 interim of the Legislature's Retirement Laws Committee was called to order by Chair Representative Matthew Michels at 9:11 a.m., December 10, 2003, in the Lake Francis Case Room of the Ramkota Inn, Pierre, South Dakota. The committee met jointly with the Board of Trustees of the South Dakota Retirement System (SDRS).

A quorum was not present with the following members answering the roll call: Senators Kenneth D. Albers, Dan Sutton, and Paul Symens; and Representatives Matthew Michels and Tim Rounds. Excused were: Senators William Earley and Clarence Kooistra; and Representatives Burt Elliott, Mel Olson, and Lou Sebert.

James Fry, Director, and Kris Schneider, Legislative Secretary, staffed the meeting.

(**NOTE:** For sake of continuity, the following minutes are not necessarily in chronological order. Also, all referenced documents are on file with the Master Minutes.)

SDRS Financial Statements

Mr. Rob Wylie, Administrator, and **Ms. Jane Roberts**, Finance Officer, reviewed SDRS's financial statements for the period ending June 30, 2003 (Document #1). Ms. Roberts reported that refunds are down 12.6% from FY 2002 and that the Plan Net Assets increased by $159,287,176. In response to a question why benefit payments were up 9%, **Mr. Paul Schrader**, Consulting Actuary, Mellon Associates, stated that this number will increase forever. He explained that the 9% increase in benefit payments is based on the following: 3% cost of living adjustment (COLA), 3% increase in number of retirees (548 people were removed from benefit payments during the last fiscal year), and a 3% change in benefits because of higher compensation.

Investment Performance Report

Mr. Steve Myers, State Investment Officer, distributed copies of an overhead presentation titled "South Dakota Retirement System Analysis, Rate of Return Comparisons" (Document #2) and reviewed the investment portfolio's performance. Mr. Myers stated that the outperformance of the fund will never be repeated in the next thirty years and that by SDRS keeping their costs low, there was an extra $5.9B in the fund. He stated that because the annualized rates of return had had consistent performance over the past thirty years, the SDRS fund ranked in the top 1 %tile for the first two decades, with annualized rates of return of 10.2 and 13.4 respectively, and in the 2 %tile for the third decade, with an annualized rate of return of 9.5.

Investment Update

Mr. Myers reported that the markets have been strong and he feels three items have been contributing factors over the past three years: 1) that the Federal Reserve has had a more aggressive policy of lowering interest rates--short term interest rates are at the lowest in the past 45 years; 2) that because of the lower interest rates, consumers are refinancing homes and pulling out extra money that they are both spending and saving; and 3) the changes in the tax policies on income, dividends, capital gains, and business credits. Mr. Myers believes that this will end come the third or fourth quarter in 2004. He viewed long-term issues as: 1) the current trade deficit of 6%, which in turn will mean higher interest rates; 2) budget deficits will remain large; 3) leveraged consumers; 4) unfunded entitlements for the baby boomers - Social Security and Medicaid; and 5) lower valuations than in the past thirty years. He gave a comparison on the fixed income side, in 1973-74 the interest rate was 7-8%, in 1982 it was 12-14%, and today it is 1.89-2%. Mr. Myers stated that he can come up with 7 ¾% but not 8%.

Actuarial Valuation

Ms. Koren Holden, Associate Principal, Retirement Actuary, Mellon Associates, stated that the SDRS fund is actuarially sound. She distributed a overhead presentation titled "2003 Actuarial Valuation Overview" (Document #3). Ms. Holden stated that as of June 30, 2003, there are 35,114 active employees in the system and that the average age of active members is 44.7 years. Thirty-five percent of the active members have 5 years or less of credited service with 10.8 years being the average. The average rate of pay for active members is $32,000. She stated that there are currently 16,400 members receiving benefits and that $191.7 million was paid out of the fund in FY 2003, a 9% increase over the prior year. Currently there are 13,500 retirees receiving benefits at an average of $12,600 per year. The average age of retirees is 69 years old. SDRS provides approximately 40% replacement ratio of income to retirees. When added to social security benefits, most retirees are receiving 75-80% of their final income. She stated that the experts say you will need 70-75% of your final pay in order to exist after retirement. Ms. Holden stated that the actuarial accrued liability funded ratio (assets to cover liabilities) increased from 96.7% to 97.2% and the actuarial value of assets increased from $4,425.4M to $4,685.9M for FY 2003. The present value of all benefits was $5,781.5M. Mr. Schrader stated that with $5.8M in the bank and if there were no new members coming into the system, there would be enough money to pay as long as the person lives with no additional contributions. If the system also met the actuarial return of 8%, it would be truly funded. The 2003 funding requirement was 12.4% of pay--11.3% for normal costs, .3% expenses, and .8% for amortization and interest. Ms. Holden stated that SDRS is 97% funded and that it had an actuarial investment loss of $(142)M and a $41M liability gain for the year. The reserve for funding of long-term benefit goals as of June 30, 2003, is $(57)M or zero, and there is no cushion for bad experience or for benefit improvements. She explained that there is $70M allocated for future years to offset the $(57)M. As far at the big picture, Ms. Holden stated that there is a cushion of $125M from deferred gains. Mr. Schrader stated that there is still a cushion because SDRS's market value of assets is greater than the actuarial value of assets. In a comparison to 44 statewide public retirement plans surveyed, SDRS ranked third in the nation.

In conclusion Ms. Holden stated that the:

- System investment experience was unfavorable for the year;
- System liability experience was slightly favorable for the year;
- System remains sound and well funded due to prior years' favorable experience;
- SDRS funded status compares very favorably with similar systems;
- Volatility in funding period and funded ratio eliminated due to treatment of investment and liability gains and losses;
- Board targets for funding period and funded ratio exceeded;
- Current normal costs continue to be high percent of contribution rate;
- Cumulative balance in reserve for funding of long-term benefit goals is $(57)M as of June 30, 2003;
- Cushion at June 30, 2003, of $125M provides only modest protection if future investment results are less than assumed 8% return; and
- Cushion reduced by 33% from FY 2002.

Ms. Holden stated that the current and future issues before the Board are:

- Managing a maturing retirement system during a sustained period of unfavorable experience;
- Communicating accurately the current and projected funded status of SDRS;
- Deciding when, and if, corrective action is advisable and the best format for change;
- Actuarial assumption review; and
- Close monitoring of future asset and liability experience.

Background of SDRS Issues under Consideration and Comprehensive Review

Mr. Wylie distributed a copy of SDRS's October 2003 "*Outlook*" (Document #4) which was mailed to all members and highlighted the reasons why changes to specific provisions in the system that are not working were being proposed. He stated that over the next year, the board would be doing a comprehensive review of SDRS that covers the current status, a review of selected plan provisions, and long-term issues.

Issues Advanced by Board of Trustees

Mr. Wade Hubbard, General Counsel, **Ms. Holden**, and **Mr. Schrader** distributed handouts (Document #5) and reviewed the following issue topics that would be discussed by the Board of Trustees for possible legislative action:

<u>Final Average Compensation Caps</u>: The issue is lump-sum payments at the end of a career may inflate a member's retirement benefit without adequate funding to support the increase.

Lump-sum payments may include termination pay, unused annual and/or sick leave, overtime, or bonuses. Final average compensation caps were put in place in 1974 to try to control both the "last pay" and "spiking."
Current provisions are: 1) compensation in last quarter cannot exceed 125% of any previous quarter; and 2) average compensation in last four quarters cannot exceed 115% of any previous quarter. The proposed changes are: 1) compensation in last quarter cannot exceed 105% of any previous quarter; and 2) average compensation in last four quarters cannot exceed 105% of any previous quarter. The result would eliminate inflating a member's retirement benefit and the projected reduction of unanticipated costs is $200 million.

Mr. Dean Hyde, representing AARP, commented that teachers who are on 9-month contract will always have a higher quarter and that their high quarter may occur before their final year.

Final Average Compensation Caps (Alternative): This is the same issue as stated above with the following proposed changes: Beginning July 1, 2004 - 1) compensation in last quarter cannot exceed 115% of any previous quarter; 2) average compensation in last four quarters cannot exceed 110% of any previous quarter; and 3) termination pay is not considered as compensation and no SDRS employer or member contributions are required. Beginning July 1, 2005 - 1) compensation in last quarter cannot exceed 105% of any previous quarter; and 2) average compensation in last four quarters cannot exceed 105% of any previous quarter. The result would eliminate inflating a member's retirement benefit and the projected reduction of unanticipated costs is $190 million.

There was some discussion that the definition of "compensation" be changed and that the Board may wish to eliminate the rule-making authority of the board.

IRC Section 401(a) Special Pay Plan: The issue is that termination pay is currently paid directly to members and is subject to Social Security taxes, SDRS contributions, and federal income taxes.

The proposed changes would create a Special Pay Plan (SPP). The termination pay would be paid directly into the SPP and there would be no Social Security tax deduction, no SDRS contributions deducted, and no federal income taxes deducted (the latter would be deferred until withdrawals are made from the SPP). The SPP would be mandatory for all members over age 55 receiving termination pay above $3,000. Each participating unit would decide if they wished to participate in the SPP. This is being proposed assuming that the SDRS proposal to eliminate termination pay from the definition of compensation becomes law. The result would be that all Class A members and their employers would each save 13.65 percent of the termination pay and allow members to defer the payment of federal income taxes until withdrawn from the SPP.

Optional Spouse Benefit: The issue is the actual costs of optional spouse benefits (OSB) exceed the contributions designed to fund them.

Under the current provisions, the OSB costs 0.8% of compensation, open enrollment is not specified and not prohibited, and the benefit is 40% of highest compensation. Under the proposed changes, the cost would increase to 1.2% of compensation, open enrollment would be prohibited, and the benefit would be 40% of the final average compensation. The OSB cost and experience will be reviewed every three years as an administrative procedure. The result will make this a self-sustaining program with a projected reduction of unanticipated costs of $15 million.

Interest on Accumulated Contributions: The issue is the current SDRS minimum interest rate of 5% is higher than current short-term savings rate and the current maximum rate of 10% exceeds the expected investment return on the fund.

The current provisions state that the interest is no greater than 90% of the 91-day US Treasury Bills for the preceding calendar year with the maximum rate 10% and the minimum rate 5%. The proposed change is setting the maximum at 8% and having no minimum. The projected SDRS savings are $30 million.

Cost of Purchase of Credited Service: The issue is the amount members pay to purchase credited service is not adequate to cover the cost of the increased benefit. A pool of assets that was set aside to offset part of these costs is depleted. The purchase rate must now cover the full cost of the increased benefit.

The current provision allows members to purchase prior service at 150% of member contribution rates. The proposed changes under Class A and Class B-Judicial are: for members less than age 45--200% of member contribution rates and for members age 45 or older--400% of member contribution rate. The proposed changes for Class B-Public Safety members are: for members less than age 35--200% of member contribution rate and for members age 35 or older--400% of member contribution rate. After July 1, 2004, current contribution rates apply for all purchases. The result will be that members who pay to purchase credited service will fully cover the cost of the increased benefits. The projected reduction of unanticipated costs is $30 million.

Retire/Rehire: The issue is members who retire, begin receiving benefits, and are rehired by an SDRS employer receive higher total payments from SDRS than comparable members who do not retire/rehire.

The current provisions under normal or special early retirement are that benefits are paid during reemployment without adjustment, a rehired member is treated as a continuing member, and the recalculated benefit paid at re-retirement considers all periods of employment. The proposed changes under the normal or special early retirement are that benefits are paid during reemployment but the COLA is suspended (except for a Class B-Public Safety member who is rehired as a Class A member), a rehired member is treated as a new member, add-on benefit paid at re-retirement considers reemployment period only, and current retirees are grandfathered in.

The current provisions under early retirement are that benefits are suspended during reemployment, rehired members are treated as continuing members, and recalculated benefit paid at re-retirement considers all periods of employment. The proposed changes under the early retirement are that benefits are paid during reemployment but the COLA is suspended (except for a Class B-Public Safety member who is rehired as Class A member), a rehired member is treated as a new member, add-on benefit paid at re-retirement considers reemployment period only, and current retirees are subject to the above provisions as of July 1, 2004. The result will make the retire/rehire practice cost neutral to the system. The projected reduction of unanticipated costs is $20 million.

Compensation Basic for Benefit Calculations: The issue is that SDRS retirement benefits are based on final average compensation (three-year average) while SDRS disability and survivor benefits are based on the highest one year pay.

The proposed change is to make all SDRS benefits based on final average compensation. The projected reduction of unanticipated costs is $13 million.

Reporting Funded Status: The issue is the language in SDCL 3-12-122 which is outdated and confusing.

The current provisions require formal report and recommendations for benefit changes to the Governor and Legislature if: 1) funding period exceeds 50 years; 2) funded ratio (actuarial value of assets) is less than 80%; or 3) decrease has occurred over three actuarial valuations. The proposed changes would be to have a formal report on the funded status of SDRS to the Governor and Legislature annually, a formal report and analysis of conditions required for improvement in funded status to the Governor and Legislature if any of the following conditions exist as of any actuarial valuation: 1) funding period exceeds 30 years; 2) funded ratio is less than 80%; or 3) market value of assets less than 90% of actuarial value of assets, and a formal report, analysis and recommendations for benefit, contribution or actuarial assumption changes required if any of the above conditions exists for three consecutive actuarial valuations. The result would clarify the triggers for when additional reporting is required.

Eligibility Requirements: The issue is that new employees can become vested by purchasing three years of credited service rather than working three years for an SDRS employer. As a consequence, they are immediately eligible for vested retirement and disability benefits. In addition, a member with prior credited service could return to employment with an SDRS employer and immediately qualify for an SDRS disability benefit.

Under the current provisions, vested retirement benefits states three years of credited service that includes purchased service and for disability benefits, three years of credited service is required unless disabled on the job, then no specific amount of credited service is required. Under the proposed changes, three years of contributory service would not include purchased service. For disability benefits, three years of contributory service since reentry into SDRS is required unless disabled at work, then no specific amount of credited service is required. The result will be that SDRS is not exposed to the cost of immediate eligibility for vested retirement or disability benefits due to purchased service. The projected reduction of unanticipated costs is $5 million.

Improvement Factor (COLA): The issue is that retirees and members that leave the system are currently paid or credited 3.1% per annum no matter what the rate of inflation is. The proposed changes are that the percent be the change in CPI-W for the prior calendar year, with the minimum set at 1.5% annually and the maximum set at 3.1% annually, effective July 1, 2006. The result will reduce future SDRS liabilities by an estimated $150 million.

Other Issues - Board of Trustees or Legislator Proposals

Chair Michels thanked the Board of Trustees for the opportunity to meet with them jointly.

Representative Rounds thanked Mr. Wylie and staff for the educational information that has been passed on, allowing him to be better informed.

Senator Albers asked that the Board of Trustees do whatever it needs to protect the system.

Legislative Session Schedule

Following a brief discussion of the legislative calendar, it was the consensus of the group that a legislative briefing be held on Thursday, January 15, 2004, at 2:00 p.m. to educate legislators on the proposed amendments to the retirement laws. Representative Michels tentatively set the bills hearing for the following Tuesday, January 20th at 3:00 p.m.

Adjournment

The chair adjourned the meeting at 4:00 p.m.

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