TO:	Members of the Legislative Commission on Pensions and Retirement
FROM:	Rachel Barth, Deputy Director
RE:	LCPR16-012: MSRS Plans; Funding Package Proposal
DATE:	February 1, 2016
ATTACHMENT:	LCPR16-012

Summary of the MSRS Funding Package Proposal

Bill draft LCPR16-012 implements the funding package approved by the Board of Directors of the Minnesota State Retirement System (MSRS), affecting the General State Employees Retirement Plan (MSRS-General), the Correctional State Employees Retirement Plan (MSRS-Correctional), the Legislators Retirement Plan, and the Unclassified Employees Retirement Program (MSRS-Unclassified).

The bill is intended to address the funding deficiencies resulting from the adoption of economic and demographic, specifically mortality, actuarial assumption changes, as a result of MSRS-General's experience study. The main components of the bill are as follows:

1. Employee Contribution Rate Increase. Section 1 amends Minn. Stat. § 352.04, subd. 2, by increasing the employee contribution rate from 5.5% to 6% on July 1, 2017, for MSRS-General and Unclassified members.
2. Employer Contribution Rate Increases. Section 2 amends Minn. Stat. § 352.04, subd. 3, by increasing the employer base contribution rate from 5.5% to 6% on July 1, 2017, for MSRS-General employing units, and Section 3 adds a new subdivision implementing an additional employer contribution of 1% on July 1, 2017, which continues until MSRS-General reaches a 100% funding ratio on a market value of assets basis. The 0.5% increase in Section 2 plus the 1% increase in Section 3 results in a combined employer rate increase total of 1.5% for MSRS-General employers; and
3. Postretirement Adjustment Revisions. Section 4 amends Minn. Stat. § 356.415, subd. 1a, which affects MSRS-General, MSRS-Correctional, the Legislators plan, and the Unclassified plan, as follows:
   - Permanently lowers the postretirement adjustment (COLA) from 2% to 1.75%;
   - Deletes the COLA triggers that permitted a COLA increase to 2.5% if the plan's funding ratio equals or exceeds 90% on a market value of assets basis for two consecutive actuarial valuations and a COLA decrease to 2% if the plan's funding ratio equals or is less than 85% on a market value of assets basis for two consecutive actuarial valuations or 80% for the most recent actuarial valuation; and
   - Specifically excludes the State Patrol and Judges plans from the above COLA changes.

These sections are effective June 30, 2016.

Background Information

The proposed legislation is intended to mitigate the MSRS-General funding deficiencies that will result from adopting the recommendations made by the plan's actuary following the completion of an experience study. The experience study analyzed economic factors and MSRS-General demographics over a six-year period to determine the accuracy of the plan's actuarial assumptions by comparing those assumptions to the plan's actual experience. The experience study recommended a number of assumption changes, most of which had a minimal financial impact or had already been adopted in the previous legislative session, like the recommendation to change the interest assumption rate from 8.5% to 8%. However, the experience study revealed that MSRS members were living on average an additional two years longer than the plan's mortality tables had assumed and recommended the adoption of the RP-2014 mortality table and the MP-2014 mortality improvement scale. The latter was later updated to the MP-2015 mortality improvement scale. The surprising rise in longevity will have a significant financial impact on MSRS-General.

The MSRS-General July 1, 2015, actuarial valuation, the plan's most current actuarial valuation, reflects the impact of the interest rate assumption change enacted in the 2015 legislative session, but used the old actuarial assumptions in place at the time. To understand the recommended assumptions' financial impact, especially the impact of the new mortality tables, the MSRS actuary applied the recommended assumptions to the 2015 actuarial valuation data and compared those results to the 2014 actuarial valuation. On a market value of assets, MSRS-General's funding ratio dropped from 92.4% to 83.9% and the plan went from a 1% funding sufficiency to a 2.8% deficiency. On an actuarial value of assets, the funded ratio dropped from 83% to 81% and the funding deficiency increased from 1.8% to 3.8%. The normal cost increased from 7.7% to 8.5% and the actuarial accrued liability increased from $12.4 to $13.8 billion, $700 million was due to the new mortality tables which had a much larger impact than the interest rate assumption change. Under the new assumptions, the expected date for the COLA to increase from 2% to 2.5%, which occurs when the plan has reached a 90% funding ratio on a market value of assets for two consecutive actuarial valuations[1], was pushed out from 2016 to beyond 2040.

In response to the projected funding deficiencies, the MSRS board approved a comprehensive funding package that is contained in the proposed legislation. The proposed legislation increases employee and employer contributions, sets the COLA to 1.75% permanently, and removes the COLA triggers. Using the 2015 valuation data and new actuarial assumptions, the package is projected, on a market value of assets basis, to decrease the actuarial accrued liability by $400 million, raise the funded ratio to 87%, create a funding sufficiency of 0.5%, lower the normal cost from 8.5% to 8.1%, and put the plan back on track to reach full funding by the plan's statutory amortization date of 2040.

Currently, employee and employer contributions are each 5.5% of covered payroll. Under the proposed legislation, the employee contribution will increase on July 1, 2017, by 0.5% to a total of 6% and the employer contribution will increase on July 1, 2017, by 1.5% to a total of 7%. The proposed legislation separates the employer contribution by raising the base rate[2] to 6% and creates a new additional employer contribution of 1%.[3] MSRS separated the employer contribution rate increase in order to keep the base employee and employer contribution rates equal. Minn. Stat. § 352.045, subd. 3a, para. (c),

[1] Minn. Stat. § 356.415.
[2] Minn. Stat. § 352.04, subd. 3.
[3] Minn. Stat. § 352.04, new subd. 3a.

allows the MSRS board to raise employee and employer contributions, subject to the Commission's review, but without legislative action, if there is a funding deficiency, but only if the increase is equal. The separate additional employer contribution is set to end when MSRS-General reaches a funding ratio of 100% on a market value of assets. The proposed legislation also lowers the COLA for MSRS-General, the Legislators plan, MSRS-Unclassified, and MSRS-Correctional from 2% to 1.75% and sets the COLA permanently at 1.75% by removing the triggers in and the ultimate 2.5% COLA increase.

Policy Considerations

Bill draft LCPR16-012 raises the following pension and public policy issues:

1. <u>Cost.</u> The proposed funding package is projected to cover the deficiencies caused by the new assumptions. The new assumptions are estimated to significantly increase the funding deficiency, and the unexpected mortality improvement have had the biggest financial impact. The new mortality tables alone increase MSRS-General's liabilities by $700 million and mortality is not expected to decrease in the future. The cost impact of paying retirement benefits for longer periods of time than expected is projected to have a long-term, negative effect on the plan's funding if no action is taken. Although the funding deficiencies are not as critical as those resulting from the Great Recession, if no funding action is taken, MSRS-General's funded ratio is projected to slowly decrease over the next 30 years, which leaves the fund especially vulnerable to market volatility.

   The proposed legislation increases funding by raising both employee and employer contributions. Raising contribution rates is projected to provide funding needed to improve the future financial stability of the plan, but will also increase costs for both the employee and employer. The cost of a 0.5% employee contribution increase is approximately $13.6 million annually and the cost of a 1.5% employer contribution increase is approximately $40.9 million annually. The increased contribution rates will not go into effect until July 1, 2017, which will give employers some time to plan for the increase, but the higher rates will tighten budgets for employers and reduce take home pay for employees.

   The proposed legislation also decreases costs by lowering the COLA from 2% to 1.75% and eliminating the COLA triggers. Reducing the COLA by 0.25% for MSRS-General, MSRS-Correctional, the Legislators plan, and the Unclassified plan will have an immediate impact on lowering the plan's liabilities and reducing the annual COLA retirees' receive. Removing the automatic trigger that increases the COLA from 2% to 2.5% for the various plans will provide funding stability and improve funding deficiencies.

2. <u>Unintended Consequences of the COLA Trigger.</u> Eliminating the COLA triggers, which determine when the COLA will increase to the maximum 2.5%, will have a significant impact on the determination of funding needs. Under the current funding policy, when the actuary determines the contributions required to keep the pension plan on track to reach full funding they take into account both the estimated date of reaching the trigger and the resulting increase in the COLA. As a result, the required contribution is larger in order to fund the higher COLA. Therefore, when a pension plan decides to address a contribution deficiency by increasing contributions, like the proposed legislation, such an increase consequently increases the plans' liabilities by speeding up the attainment of the trigger and the resulting COLA increase. So, If MSRS were to address the increased contribution deficiency by only increasing contributions and leaving the COLA increase trigger in

place, the increased contributions would consequently increase the plans' liabilities by speeding up the attainment of the trigger and the resulting COLA increase. Because of the trigger, an increase in contributions would worsen, rather than improve, the funded status and contribution deficiency. In other words, the COLA increase, upon attainment of the trigger, is being funded by both current employee and employer contributions and actuarial gains.

Creating a permanent 1.75% COLA by removing the trigger to increase the COLA to 2.5% will have a greater impact on current employees than current retirees. According to the most recent MSRS-General cost impact study that applied all of the new assumptions to 2015 member data, the date at which the COLA was expected to increase from 2% to 2.5% was pushed out to occur in about 30 years. Current employees are more likely to receive the higher 2.5% COLA if the triggers are not removed. However, if MSRS-General's deficiencies are not properly funded and the markets continue their current downward trend, contribution rates will have to continue increasing to keep the date on which the COLA is expected to increase from getting pushed further out into the future. Although current employees are more likely to receive the 2.5% COLA increase, they will eventually have to contribute more to the fund to ensure the increase. The COLA trigger is not a sustainable way to provide for a higher COLA.

3. <u>Equity.</u> The proposed legislation impacts active members, retirees, and employers. Under the proposed legislation, employees' contributions will increase by 0.5% and they will receive a lower COLA when they eventually retire than current retirees have been receiving. An increase in contributions means a decrease in take home pay, but the contributions are deducted from pre-tax compensation which reduces the impact of the increase. MSRS-General employees currently pay the lowest contribution rate in comparison to the other Minnesota public pension plans by 1-2%. Under the new mortality tables, active members are expected to live longer than past generations, which means they will be collecting benefits longer than past generations. This additional liability will be partially offset by raising the employee contributions for the active members who are expected to collect benefits longer. At a 6% contribution rate, MSRS-General employees will still comparatively pay the lowest rates among the other pension plans. On the other hand, retirees are also living longer than expected, which increases costs, so it may be inequitable to raise employee contributions even more to cover the costs of a different generation.

   Employers are also impacted by the proposed legislation, which increases the employer's base contribution rate by 0.5% and implements an additional employer contribution of 1% that will end when the MSRS-General fund reaches a funded ratio of 100% on a market value of assets. MSRS-General employers currently pay the lowest employer contribution rate compared to other Minnesota pension plans by 2%. If the proposed legislation is enacted, the contribution rate will still be 0.5% lower than the other plans' employer contribution rates. The Legislative Commission on Pensions and Retirement's (LCPR) Principles of Pension Policy supports the philosophy that the employees and employers share the burden of paying the plan's normal cost on a relatively equal basis. Currently, the employees fund approximately 65% of the normal cost, which means employees are funding a larger portion of their retirement than what may seem equitable because a large portion of the employers' contributions go towards paying off the unfunded liability. The plan's liabilities are going to increase due to the rising longevity of both retirees and current employees. The unfunded liability is made up of past debts and part of the new liability is attributable to retiree mortality rates, so employees may feel it is unfair for their contribution rates to increase to pay for debts they did not contribute to. The increased employer contribution will fund both the plan's normal cost and a larger portion of the unfunded liability. The proposed legislation requires both to contribute more, which will help pay for the unfunded liabilities and the future costs of improved mortality.

Under the proposed legislation, current retirees' COLAs will be permanently reduced by 0.25%, which will have an impact on the benefit amount especially due to compounding, but they have benefited from 2% COLAs for past years of retirement. When current employees retire, they will receive a lower COLA than past and current retirees. However, both groups are projected to live longer than their predecessors, so the fund will be paying benefits for longer periods of time than anticipated. The expense of paying benefits longer, coupled with the low market returns, can be partially alleviated by lowering the COLA. Further, if the trigger is not eliminated, current retirees are not likely to receive the 2.5% COLA increase unless a significant funding increase is implemented to move the trigger date closer. The funding increase would have to be large enough to offset the increased liabilities of moving the trigger date up and paying a higher COLA. Such a large funding increase would likely have to come from higher contributions or benefit reductions for newly hired employees, which could be seen as inequitable wealth distribution from current employees to retirees.

The intent behind COLAs is to ensure that a retiree's benefit maintains its value against inflation. Over the past several years, inflation has been historically low. For example, based on the low inflation rates, Social Security will not be providing a COLA for benefits distributed in 2016. In the current economic environment of low interest rates and poor stock market returns, a COLA rate that better reflects the economy would be in accordance with the intent behind a COLA. Also, lowering the COLA does not mean that the COLA could never be increased in the future if and when higher rates of inflation return.

4. Appropriate Timing and Scope of Proposal. The proposed legislation is in response to the unexpected rise in mortality improvement and the resulting increased funding deficiency, which the MSRS board determined needed immediate remedy. The impact on the MSRS-General fund is significant, but the immediate need for action is not as critical as it was back in 2009. If no action is taken, the plan is not projected to default but the funded ratio will slowly decline over the next 30 years. However, that projection is based on the assumption that the investment returns will be 8% every year. The investment returns could vastly improve and prevent the future decline, but the current investment return for the current fiscal year through December 2015 is –8% and if that pattern continues, the plan's funded ratio will decline at an accelerated rate. No action leaves the fund in a vulnerable position. Further, mortality rates are only expected to improve, so longevity is a reality that must be faced. The impact of the new mortality tables are not expected to be offset by future gains from higher mortality rates, so any delay in increasing plan funding will only increase the costs when action is finally taken. Also, addressing mortality now will get a jump on the probable need to address a reduction in the interest assumption rate in the future. The MSRS actuary and Deloitte (the Commission's actuary) both recommended the interest assumption rate should be between 7-8%, suggesting a lower rate will eventually need to be considered.

   The proposed legislation focuses mostly on the MSRS-General plan, but it reduces the COLA and removes the triggers for the MSRS-Correctional plan. The actuary is currently working on an experience study on the MSRS-Correctional, so the extent to which current assumptions are inconsistent with actual experience is currently unknown. However, the 2015 actuarial valuation of the MSRS-Correctional plan revealed that on an actuarial value of assets the plan's funding ratio is 70.9%, there is a 5.5% contribution deficiency, and the COLA was never expected to increase to 2.5%. Removing the COLA triggers and reducing the COLA from 2% to 1.75% increased the funding ratio to 72.7% and lowered the funding deficiency to 4.2%. The significant contribution deficiency indicates the need for immediate action, rather than waiting for the experience study results, to ensure the stability of the fund. The fund was struggling to finance a 2% COLA and the impact of lowering the COLA and removing the triggers supports the revisions, especially when the COLA was never expected to increase to 2.5%.

The proposed legislation does not remove the COLA triggers for the State Patrol plan or the Judges plan. Neither plan completed an experience study this year, so the plans have not adopted new assumptions. The State Patrol plan's COLA is currently at 1% and the Judges plan's COLA is currently 1.75%. According to the 2015 actuarial valuations, the State Patrol plan has a funding ratio of 76.81% on an actuarial value of assets and a 7.98% contribution deficiency and the Judges plan has a funding ratio of 53.3% on an actuarial value of assets and an 11.9% contribution deficiency. Both plans have higher contribution deficiencies than both MSRS-General and MSRS-Correctional, which could be improved if the COLA triggers are removed. However, both plans currently have lower COLA's than MSRS-General and MSRS-Correctional, so neither plan would benefit from the COLA reduction to 1.75%. The State Patrol and judges plans are not as well funded as MSRS-General or MSRS-Correctional, but the plans also do not have the results of experience studies to help create a comprehensive funding package.