TO:	Members of the Legislative Commission on Pensions and Retirement
FROM:	Rachel Barth, Deputy Director
RE:	LCPR16-014: TRA; Funding Package Proposal
DATE:	February 2, 2016
ATTACHMENTS:	LCPR16-014; TRA Reemployed Annuitants Revisions Handout

Summary of the TRA Funding Package Proposal

Bill draft LCPR16-014 implements the funding package approved by the Board of Trustees of the Teachers Retirement Association (TRA).

The bill is intended to address the funding deficiencies that resulted from the adoption of economic and demographic, specifically mortality, actuarial assumption changes recommended in TRA's experience study. As part of the funding proposal, the proposed legislation implements certain reemployed annuitant reforms. The main components of the bills are as follows:

1. <u>Employer Contribution Rate Increase</u>. Section 1 amends Minn. Stat. § 354.42, subd. 3, by increasing the employer contribution rate for coordinated members from 7.5%[1] to 8.5% on July 1, 2017.

2. <u>Revisions Related to Reemployed Annuitants</u>. *(see TRA Reemployed Annuitants Revisions Handout)*
   - <u>Employer Contributions</u>. Section 1 also amends Minn. Stat. § 354.42, subd. 3, by adding a new paragraph stating that starting July 1, 2017, employers are required to pay regular employer contributions (8.5%) on behalf of reemployed annuitants.
   - <u>Annuity Deferral Amount Decreased; Future Forfeiture</u>. Section 2 amends Minn. Stat. § 354.44, subd. 5, by decreasing the amount of the annuity deferral for reemployed annuitants from an amount equal to one-half of the annuitant's salary in excess of $46,000 to an amount equal to one-third of the annuitant's excess salary, and by adding a new paragraph that, starting July 1, 2020, the deferred amounts will be forfeited to the TRA fund.

3. <u>Amortization Period Extended</u>. Section 3 amends Minn. Stat. § 356.215, subd. 11, para. (d), by extending the TRA amortization period from June 20, 2037, to June 30, 2046.

4. <u>Postretirement Adjustment Revisions</u>. Section 4 amends Minn. Stat. § 356.415, subd. 1d, as follows:
   - Temporarily lowers the postretirement adjustment (COLA) from 2% to 1%, effective January 1, 2017, through December 31, 2021.
   - Permanently sets the COLA to 1.75% on January 1, 2022.
   - 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 for two consecutive actuarial valuations and a

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[1] *This percentage does not include supplemental contributions from matching state contributions, state aid for Duluth merger, School District #1, or the City of Minneapolis.*

COLA decrease to 2% if the plan's funding ratio equals or is less than 85% on a market value of assets for two consecutive actuarial valuations or 80% for the most recent actuarial valuation.

All provisions are effective upon final enactment.

Background Information

The proposed legislation is intended to mitigate TRA's funding deficiency that will result from adopting the recommendations made by the plan's actuary following completion of the experience study. The experience study analyzed economic factors and TRA's 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 revealed that TRA members were living on average an additional two years longer than the plan's mortality tables had assumed. As a result, the actuary 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 scale. The surprising rise in longevity will have a significant financial impact on TRA along with the other recommended assumption changes, including the change proposed in LCPR16-021 to reduce the interest rate assumption from 8.5% to 8%.

The TRA July 1, 2015, actuarial valuation, the plan's most current actuarial valuation, used the actuarial assumptions in place at the time. To understand financial impact of the recommended assumptions, especially the impact of the new mortality tables, the TRA 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, TRA's funding ratio dropped from 82% to 75% and the plan went from a 0.07% funding deficiency to a 4.21% deficiency. On an actuarial value of assets, the funded ratio dropped from 74% to 73% and the funding deficiency increased from 3.47% to 5.31%. The actuarial accrued liability increased from $24.5 to $27.1 billion. 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[2], was extended from 2037 to never occurring.

In response to the projected funding deficiency, the TRA board approved a comprehensive funding package that is contained in the proposed legislation. The proposed legislation increases employer contributions on July 1, 2017, from 7.5% to 8.5% and requires employers to begin paying contributions for reemployed annuitants. The reemployed annuitant provision is revised to require that the pension benefit being paid to a reemployed retiree, who has not yet attained the normal retirement age and who is earning more than the $46,000 maximum, will be reduced by one-third, rather than the current one-half, for every dollar that the retiree's earnings exceed the maximum amount. This deferred benefit is eventually distributed to the retiree. Starting in 2020, however, the deferred benefit will be forfeited to the TRA fund. Also under the proposed legislation, the amortization period is extended by nine years, the COLA is lowered from 2% to 1% for five years and then 1.75% thereafter, and the COLA triggers are removed. Using the 2015 valuation data and new actuarial assumptions, the package is projected, on a market value of assets, to decrease the actuarial accrued liability by $1.1 billion, raise the funding ratio to 78%, lower the funding deficiency to 0.3%, and put the plan back on track to reach full funding by the plan's proposed statutory amortization date of 2046.

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[2] Minn. Stat. § 356.415.

Policy Considerations

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

1. Cost. 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, with the improvement in mortality rates and reduction from an 8.5% to 8% interest rate assumption having the biggest financial impact. A significant portion of the increase in TRA's actuarial accrued liability is attributable to the new mortality tables 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, TRA's funding ratio is projected to flat-line at a 74% funding ratio over the next 30 years, which leaves the fund especially vulnerable to market volatility.

   The proposed legislation increases funding by raising the employer contribution rate by 1%. The cost of a 1% employer contribution increase is approximately $43 million annually. The increased contribution rate will not go into effect until July 1, 2017, which will give employers some time to plan for the increases. Also, as of July 1, 2017, employers will be required to contribute 8.5% on behalf of reemployed annuitants, which will cost employers an additional $3 to $4 million annually and will tighten budgets further.

   The proposed legislation also decreases costs by lowering the COLA from 2% to 1% for five years and 1.75% thereafter and eliminating the COLA triggers. Reducing the COLA by 1% will have an immediate impact by lowering the plan's liabilities and reducing the annual adjustment retirees' receive. Eliminating the COLA triggers, which determine when the COLA will increase to the maximum 2.5%, reduces the actuarially determined required contribution by 1% of payroll.

2. Unintended Consequences of the COLA Trigger. 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, If TRA 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 plan's liabilities by speeding up the plan's attainment of the trigger and the resulting COLA increase. Because of the trigger, an increase in contributions has the counter-intuitive effect of worsening, rather than improving, TRA's 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 COLA increase trigger will lower the required contributions by 1% of covered payroll and will not have much of an actual impact on either employees or current retirees. According to the TRA cost impact study that applied all of the new assumptions to 2015 member data, the date on which the COLA would increase from 2% to 2.5% was never expected to occur. If no action is taken, neither current retirees nor employees will receive the higher 2.5% COLA. If the triggers were to stay in place, there would have to be a significant funding increase, beyond what is proposed in LCPR16-014, in order for the current employees to receive the 2.5% COLA. 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. However, even with significant funding increases, the date on which the COLA is expected to increase will continue to get pushed out into the future if TRA's deficiencies are not properly funded and the markets continue their current downward trend. The COLA trigger is not a sustainable way to provide for a higher COLA.

3. Amortization Period Extension. The proposed legislation also extends the date by which the plan will reach full funding by nine years, from 2037 to 2046. The extension will stretch TRA's amortization period to the full 30 years, which is the maximum period generally accepted accounting principles in the public sector allow. Extending the amortization period does not increase the plan's funding nor does it cut costs per se. Instead, the extension merely shifts costs into the future and gives the plan a longer period of time to pay off the old and new unfunded liability. All Minnesota public pension funds use a fixed-date, level percentage of payroll amortization method, which attempts to keep retirement plan funding consistent over time as a percentage of covered payroll rather than a dollar amount. The level percentage of increasing payroll amortization will not pay full interest on the unfunded actuarial accrued liability during the initial portion of the amortization period, so the dollar amount of the unfunded actuarial accrued liability during that portion of the amortization period will increase even if all actuarial assumptions are met precisely and will produce a set of balloon payments during the final portion of the amortization period.

   The weakness of a fixed-date, level percentage of payroll amortization method is that near the end of the amortization period, there will be significant volatility in the required contribution rate due to the large size of those balloon payments. Those balloon payments will likely require the plan to extend the amortization date in order to afford the amortization payment, which means the unfunded liability will likely never be fully paid and is the less preferred method to address the volatility concern according to TRA's experience study. The extension of the amortization period is part of the full funding package that will set TRA back on track to reach full funding. Without the extension, other funding sources would be needed, but the continued practice of extending the full payment of liabilities will never fully solve the funding problems. Both the Commission staff and the TRA actuary, as stated in the TRA experience study, think a greater understanding of different amortization methods would be beneficial.

4. Equity. The proposed legislation impacts employers, active members, and retirees. Currently, TRA's employee contribution rate is 7.5%, which is higher than both MSRS-General and PERA-General, and the employer contribution rate is 7.5%, which is higher than MSRS-General and the same as PERA-General. The proposed legislation does not increase employee contribution rates, but does increase the employer contribution from 7.5% to 8.5%. If the proposed legislation is enacted, the TRA employer contribution rate will be the highest compared to the other two plan. The Commission's Principles of Pension Policy support the philosophy that the employees and employers share the burden of paying the plan's normal cost on a relatively equal basis. Currently, TRA employees fund approximately 75% 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 only going to increase due to

the rising longevity of both retirees and current employees. The increased employer contribution will fund both the plan's normal cost and a larger portion of the unfunded liability. A portion of the new additional 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. However, another portion of the new additional liability is attributable to current member mortality rates, so employers may feel it is unfair that the employees are not required to pay part of the debt to which they are contributing.

Employers and retirees will also be impacted by the reemployed annuitant provision revisions. Currently, when a retiree receiving an annuity returns to TRA-covered employment, neither the employer nor the retiree make contributions and the retiree does not earn additional service credit. The proposed legislation requires employers to make regular contributions for reemployed annuitants, but reemployed annuitants will not be required to make contributions and will not earn additional service credit. These contributions will be an additional cost to employers and are intended by TRA to remove the incentive for employers to hire reemployed annuitants over active members in order to avoid paying the contributions. So, the required employer contribution will not benefit the retiree and the only purpose appears to be equalizing the employer cost of hiring retirees versus actives. As a result, it may be more challenging for retirees to find TRA-covered employment, but continuing to work in a covered position while receiving an annuity from the same plan is not the intent of a pension.

The proposed legislation will also lower the amount TRA deducts from a reemployed retiree's annuity for salary earned above the maximum from one-half to one-third of the excess. Currently, the excess amount is eventually given back to the retiree, but under the proposed language the amount will be forfeited to TRA starting July 1, 2020. The forfeiture will provide an actuarial gain for TRA, but will temporarily lower a reemployed retiree's annuity. A pension is meant to provide income for when an individual retires. Receiving a salary from employment covered by the same pension plan that is simultaneously paying the employee a pension benefit could be perceived as "double-dipping." Implementing the forfeiture would help discourage that notion. The maximum is still high enough that a majority of retirees who come back, typically as substitute teachers, will not be discouraged by the forfeiture, which would likely not affect them because approximately 82% of reemployed retirees earn less than $10,000 per year.

The proposed legislation's COLA revisions impact both employees and current retirees. Current retirees' COLAs will be permanently reduced by 1% for five years and then 0.25% thereafter, which will have an impact on the benefit amount especially due to compounding. 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 TRA 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.

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.

5. Appropriateness of the Timing of the Proposal. The proposed legislation is in response to the increase in mortality improvement and lower interest rate assumption, resulting in increased funding deficiency. The TRA board determined that action was necessary. The impact on the TRA 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 flat-line 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. TRA's actuary and Deloitte both recommended the interest assumption rate should be between 7 to 8%, suggesting a lower rate will eventually need to be considered.