State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director

RE: Post-Retirement Adjustment Mechanism and Retirement Plan Funding Ratio Changes

DATE: October 26, 2011

Introduction

During the course of the October 19-20, 2011, meeting of the Legislative Commission on Pensions and Retirement, Pat Anderson, on behalf of the Minnesota Free Market Institute, testified that a downsizing of the interest rate actuarial assumption would have an advantage of producing smaller future post-retirement adjustments. Following those comments, Representative Mary Kiffmeyer observed that the post-retirement adjustment mechanisms of some of the statewide defined benefit retirement plans could experience a repeating pattern of periodic increases and subsequent reductions in their post-retirement adjustment rate based on their market value of assets funding ratio and suggested that this circumstance needs to be taken into account in assessing actuarial liabilities.

These October 19-20, 2011, comments and observations indicate that the Commission may desire a description of the tie between post-retirement adjustment rates for the statewide and major local defined benefit retirement plans, the funded condition of these retirement plans, and the funding ratio impact of potential interest rate actuarial assumption changes.

2010-2011 Statewide and Major Local Defined Benefit Retirement Plan Post-Retirement Adjustment Rate Legislation

During the 2010 and 2011 Legislative Sessions, legislation nicknamed financial sustainability legislation was enacted that provided for reductions in future post-retirement adjustments based on the funded condition of the particular retirement plan.

In 2010 (Laws 2010, Ch. 359, Art. 1, Sec. 76-82), the future post-retirement adjustment rates of the various statewide defined benefit retirement plans and of the Duluth Teachers Retirement Fund Association (DTRFA) were reduced based on the funded ratio of the respective retirement plan, as follows:

Retirement Plan	Funded Ratio Trigger	Post-Retirement Adjustment Rate Limit
Minnesota State Retirement System (MSRS) Plans:		
General State Employees Retirement Plan (MSRS-General)	MVA < 90%	2.0%
Correctional State Employees Retirement Plan (MSRS-Correctional)	MVA < 90%	2.0%
Unclassified Employees Retirement Program (MSRS-Unclassified)	MVA* < 90%	2.0%
Judges Retirement Plan	MVA < 90%	2.0%
Legislators Retirement Plan	MVA* < 90%	2.0%
Elected State Officers Retirement Plan	MVA* < 90%	2.0%
State Patrol Retirement Plan	MVA < 90%	1.5%
Public Employees Retirement Association (PERA) Plans:		
General Employees Retirement Plan (PERA-General)	MVA < 90%	1.0%
Local Government Correctional Service Retirement Plan (PERA-Correctional)	MVA < 90%	1.0%
Public Employees Police and Fire Retirement Plan (PERA-P&F):		
as of 1/1/2011 and 1/1/2012	--	1.0%
after 12/31/2012	MVA < 90%	1.5%
Teachers Retirement Association (TRA)		
as of 1/1/2011 and 1/1/2012	--	0.0%
after 12/31/2012	MVA < 90%	2.0%
Duluth Teachers Retirement Fund Association (DTRFA)	MVA < 80%	0.0%
	MVA >79%< 90%	1.0%
	MVA > 89%	2.0%

**Funded ratio trigger is based on the funded ratio of MSRS-General rather than of the respective retirement plan.*

MVA = Market Value of Assets funded ratio

Once the funded-ratio based post-retirement adjustment limit trigger is exceeded, all of the indicated retirement plans other than PERA-P&F and DTRFA return to a flat 2.5% annual post-retirement adjustment enacted in 2009 (Laws 2009, Ch. 169, Sec. 73). For PERA-P&F, once the funded ratio-based post-retirement limit trigger is exceeded, annual post-retirement adjustments equal to the increase in the federal Consumer Price Index-All Urban Wage Earners (CPI-U), up to 2.5% annually, would be payable. For DTRFA, once the retirement plan is funded on an actuarial value of assets basis at 90% or greater, an annual post-retirement adjustment equal to the CPI-U increase, up to 5%, would be payable.

In 2011 (First Special Session Laws 2011, Ch. 8, Art. 2, Sec. 3-5), the future post-retirement adjustment rates of the St. Paul Teachers Retirement Fund Association (SPTRFA) were reduced based on the funded ratio of the retirement plan calculated on an actuarial value of assets basis to 1% when the funded ratio is less than 80%, to 2% when the funded ratio is at least 80% and less than 90%, and to the CPI-U increase, up to 5%, when the funded ratio once reaches 90%.

Potential Yo-Yoing of Annual Post-Retirement Adjustment Rates

For some of the Minnesota statewide retirement plans, there is a possibility that the retirement plan may become sufficiently funded at some future date to return to full 2.5% annual post-retirement adjustments, but upon that return, the actuarial accrued liability associated with the greater post-retirement adjustment rate may, in the next actuarial valuation report, drive the funded ratio below the funded ratio-based post-retirement adjustment rate limit trigger, with a re-imposition of the post-retirement adjustment rate limit trigger, producing a subsequent actuarial gain that may lead to a subsequent determination of financial sustainability, potentially recurring again and again.

The retirement plans subject to this potential funded ratio-based post-retirement rate limitation yo-yoing based on differences between Minnesota Statutes, Sections 356.415, Subdivision 1b, Paragraph (c), and Minnesota Statutes, Section 356.415, Subdivisions 1a, 1c, 1d, and 1e, are PERA-General and PERA-Correctional.

The statutory provision that gives rise to this potential yo-yoing phenomenon was intentional, although the actual confusion that may result from the potential yo-yoing unlikely was intentional. Whether the potential yo-yoing phenomenon will be an actual problem that may require future legislative attention remains to be seen.

Impact of Actuarial Assumption Changes on Future Post-Retirement Adjustment Rates

Any change in the actuarial assumptions of the Minnesota statewide or major local retirement plans, either by statutory change for interest, salary increase, or payroll increase actuarial assumptions, or by approval by the Pension Commission for all other actuarial assumptions, will increase or decrease the actuarial accrued liability of the applicable retirement plan in subsequent actuarial valuation reports. Because the funded ratio of each plan is a function of the value of retirement plan assets (generally determined at market value for post-retirement adjustment rate reduction trigger purposes, but at actuarial value for DTRFA and SPTRFA), expressed as a percentage of the actuarial accrued liability of the retirement plan (or MSRS-General for the Legislators Plan, the Elected State Officers Plan, or MSRS-Unclassified), increasing actuarial accrued liability through an actuarial assumption change at this time, before financial sustainability is obtained, will reduce the funded ratio and prolong the current limited post-retirement adjustment rates. A comparable decrease in actuarial accrued liability through an actuarial assumption change will increase the funded ratio and shorten the period during which the current limited post-retirement adjustment rates will be in force.

Because there is a direct tie between actuarial assumption changes and post-retirement adjustment limitations, the process used in establishing a revised actuarial assumption rate may come under increased scrutiny by the affected retirement annuity or benefit recipients and could lead to future litigation. For most actuarial assumption changes, the proposal for change typically emanates from a quadrennial experience study, where the study identifies the deviation of the expected experience under past actuarial assumption from the actuarial experience measured and indicates (and argues that) the expected experience under the new actuarial assumption is a better match. In the area of a potential change of the interest rate actuarial assumption, where the most recent quadrennial experience studies did not include any comparison of the expected experience with the actual recent experience, where the quadrennial experience studies based their recommendation for an assumption rate reduction on undisclosed internal proprietary investment performance forecasts, and where the quadrennial experience studies indicated that the current actuarial assumption is within the reasonable range (albeit at or near the top of that range), any assumption change will be based on less quantifiable determinants and will be open to more speculation than evidence. If a change in the interest rate actuarial assumption is made and the change postpones (or eliminates) any potential for a return to the regular post-retirement adjustment rates, there may be scrutiny

by adversely affected retirees and near retirees. If any interest rate actuarial assumption change could be characterized upon outside judicial or other review as arbitrary, capricious, or lacking foundation, litigation to reverse the interest rate actuarial assumption change could follow.

To demonstrate the impact of a potential interest rate actuarial assumption change, following a rough rule-of-thumb that a 2.5% reduction in the interest rate assumption (8.5% to 6.0%) would produce a 30-40% increase in the retirement plan actuarial accrued liability, the following would be the potential results, based on current (July 1, 2010) actuarial valuations:

Increase in 2010 Actuarial Accrued Liability at 6.0% Interest

Plan	8.5% Interest Assumption	6.0% Interest Assumption		
MSRS-General	$10,264,071,000	$13,343,292,000	-	$14,369,699,000
MSRS-Correctional	851,086,000	1,106,412,000	-	1,191,520,000
Judges	240,579,000	312,753,000	-	336,811,000
State Patrol	483,360,000	888,368,000	-	956,704,000
PERA-General	17,180,956,000	22,335,242,000	-	24,053,338,000
PERA-P&F	5,963,672,000	7,752,774,000	-	8,349,141,000
PERA-Correctional	248,867,000	323,527,000	-	348,414,000
PERA-MERF Division	1,286,151,000	1,671,996,000	-	1,800,611,000
TRA	22,081,634,000	28,706,124,000	-	30,914,287,000
DTRFA	312,649,572	406,444,440	-	437,709,390
SPTRFA	1,471,630,000	1,913,119,000	-	2,060,282,000
Total	$60,584,655,572	$78,760,051,440	-	$84,818,516,390

Increase in 2010 Unfunded Actuarial Accrued Liability at 6.0% Interest

Plan	8.5% Interest Assumption	6.0% Interest Assumption		
MSRS-General	$1,303,680,000	$4,382,901,000	-	$5,409,308,000
MSRS-Correctional	247,223,000	502,549,000	-	587,657,000
Judges	95,851,000	168,025,000	-	192,083,000
State Patrol	116,149,000	321,157,000	-	389,493,000
PERA-General	4,053,963,000	9,208,249,000	-	10,926,345,000
PERA-P&F	775,333,000	2,564,435,000	-	3,162,802,000
PERA-Correctional	6,848,000	81,508,000	-	106,395,000
PERA-MERF Division	442,118,000	827,963,000	-	956,033,000
TRA	4,758,488,000	10,823,716,000	-	13,031,879,000
DTRFA	57,340,659	151,135,527	-	182,400,477
SPTRFA	470,186,000	911,675,000	-	1,058,838,000
Total	$12,327,179,659	$29,943,313,527	-	$36,003,233,477

Change in 2010 Funded Ratio at 6.0% Interest

Plan	8.5% Interest Assumption	6.0% Interest Assumption		
MSRS-General	87.30%	67.15%	-	62.36%
MSRS-Correctional	70.95%	54.58%	-	50.68%
Judges	60.16%	46.28%	-	42.97%
State Patrol	83.00%	63.85%	-	59.29%
PERA-General	76.40%	58.77%	-	54.57%
PERA-P&F	87.00%	63.92%	-	62.14%
PERA-Correctional	97.25%	74.81%	-	69.46%
PERA-MERF Division	65.73%	50.48%	-	46.87%
TRA	78.45%	60.35%	-	56.04%
DTRFA	81.66%	62.82%	-	58.33%
SPTRFA	72.20%	54.88%	-	50.96%

Increase in 2010 Amortization Contribution at 6.0% Interest

Plan	8.5% Interest Assumption	6.0% Interest Assumption		
MSRS-General	$74,200,000	$249,456,000	-	$307,875,000
MSRS-Correctional	14,637,000	29,754,000	-	34,793,000
Judges	5,982,000	10,486,000	-	11,988,000
State Patrol	7,176,000	19,842,000	-	24,064,000
PERA-General	298,280,000	677,519,000	-	803,932,000
PERA-P&F	45,881,000	151,753,000	-	187,163,000
PERA-Correctional	685,000	8,153,000	-	10,643,000
PERA-MERF Division	45,846,000	85,857,000	-	99,194,000
TRA	287,781,000	654,590,000	-	788,134,000
DTRFA	3,627,424	9,560,976	-	11,538,836
SPTRFA	28,325,000	54,921,000	-	63,787,000
Total	$812,420,434	$1,951,891,926	-	$2,343,110,826

If the Commission were to propose an interest rate actuarial assumption change of the magnitude of a 2.5% reduction, it could be expected that the members of PERA-Correctional, PERA-P&F, and the Judges Retirement Plan would be very concerned. For PERA-Correctional members, a change of this magnitude would reverse that plan's expected January 1, 2012, resumption of a full 2.5% annual post-retirement adjustment rate. For PERA-P&F members, a change of this magnitude would postpone a likely near-term resumption of a full post-retirement adjustment. For Judges Retirement Plan members, largely because of the late date at which the retirement plan was placed on a full actuarial funding process, the resumption of full post-retirement adjustments under a change of this magnitude would recede from the distant future to unforeseeable.

Because of the interconnection of benefit provisions to funded status by the 2010 and 2011 Legislative Sessions, an added policymaking factor arises in conjunction with the consideration of a potential change in such a significant assumption as the interest rate actuarial assumption.

Conclusion

The Commission staff hopes that this consideration of the recent post-retirement adjustment legislation and its interplay with potential actuarial assumption changes is of assistance. If members of the Commission have questions about this topic, the Commission staff would be happy to further research and analyze the question.