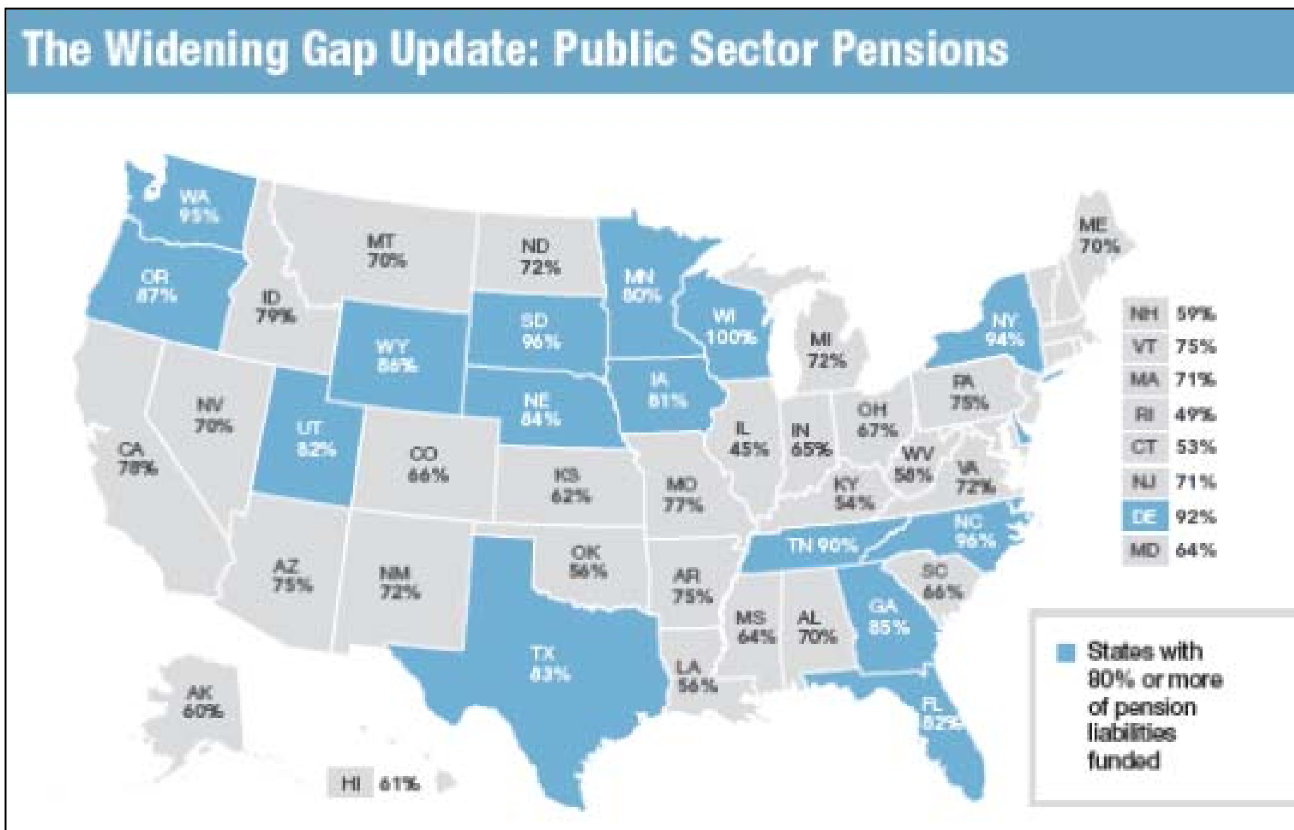
State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

TO:	Members of the Legislative Commission on Pensions and Retirement
FROM:	Ed Burek, Deputy Director
RE:	Review of Minnesota Defined Benefit Public Employee Retirement Plan Post-Retirement Adjustment Mechanisms: Survey of Post-Retirement Adjustment Procedures in Comparable States
DATE:	October 17, 2013

Introduction

At the Commission's September 12, 2013, meeting, Commission staff was asked to survey other states that have pension systems in similar actuarial condition to that of Minnesota, and to report on the post-retirement adjustment procedures those states are using.

This memo attempts to identify comparable states by relying on a June 2012 issue brief by the PEW Center on the States called "The Widening Gap Update." In that document, which deals with the gap between public pension fund assets and liabilities, PEW identifies states where the pension plans are at least 80% funded (have a funding ratio of at least 80%). According to the analysis, which is based on fiscal year 2010 data, 16 of the 50 states make that cutoff. The group with at least an 80% funding ratio includes Minnesota and several surrounding states.



NOTE: Based on Fiscal Year 2012 data.
SOURCE: Pew Center for the States 2012 *(http://www.pewstates.org/State-Pensions-Update)*

Before proceeding further, we should mention that PEW's effort to report state funding ratios is subject to considerable error. The funding ratios are the result of the actuarial procedures and assumptions which each state is using, as reported by the states. Since assumptions and methodology differ between states (and between plans in a given state), comparisons of funding ratios across states is an apples-to-oranges comparison. If all these states were using similar assumptions and the same actuarial method, the results would differ, perhaps radically, from those reported by PEW.

Consider, for example, the implication of the different rate of return assumptions used across states. Commission members are aware, based on presentations and discussion in the last few years, that there is a considerable range of investment return assumptions across the states, ranging from 8.5% on down. The lower the investment return assumption, the greater the computed plan liabilities and thus the lower the

funding ratio. Mortality and demographic assumptions differ. Even if everything else were the same except for the asset smoothing methodology, the results will differ. Actuarial value is used to smooth the changes in market value over time. If one state recognizes more of the difference between market value and actuarial value than another state, the computed funding ratios will differ.

A final comment regards the use of different actuarial methodologies. Different methodologies applied to the same data would yield different computed funding ratios. In the PEW presentation, Wisconsin has the highest funding ratio of any state, 100%. This might be an artifact of Wisconsin's methodology. Wisconsin uses an actuarial methodology rarely used by public plans, the "entry age frozen initial liability method." Information available on the internet suggests that under that methodology the unfunded liability (if any) that existed when the plan was first created is recognized. But after the initial unfunded liability is paid off, no unfunded liability is recognized thereafter regardless of the experience of the plan. Consider a shock to the plan, such as a large loss of asset value due to the Great Recession. Under the entry age normal method used by Minnesota and most other states, the computations would indicate an unfunded liability, to be amortized through an amortization contribution. Under the Wisconsin approach, the needed contribution amounts may instead be captured by the normal cost computation. A consequence of the procedure is that the computed funding ratio is always 100%.

The Great Recession decimated pension fund asset values. Prior to that, Minnesota had plans with very high funding ratios, including some in past years that were considerably in excess of 100%. Plans now are recovering from the market value hit which occurred in 2008-2009. According to the PEW material, by fiscal year 2010, Minnesota had climbed back to 80% funded while Wisconsin was 100% funded. It seems odd that either Wisconsin somehow avoided the Great Recession market value losses, or was able to fully recover far quicker than plans in any other state.

Survey of Other States with High Reported Funding Ratios

With the previous reservations, the following provides the following survey of post-retirement adjustment procedures used in states located in the northern half of the county and which PEW identified as having at least 80% funding ratios in fiscal 2010. In considering the options indicated in the memo, Commission members way wish to consider that the approach being used by a given state may reflect recent pension fund actuarial problems, rather than the policies which that state's legislature would support in more normal times. The post-retirement procedures may also reflect a legislature's failure to more directly address other problem areas. Rather than discourage early retirement directly by revising early retirement ages or by reducing or eliminating subsidies for early retirement, that legislature may be discouraging early retirement by providing inadequate post-retirement adjustments. Similarly, a legislature may be providing inadequate post-retirement adjustments to offset benefits at the time of retirement which are deemed to be excessive.

a. Wisconsin

- Reported funding ratio: 100%.
- Post-Retirement Procedure. Wisconsin provides adjustments to retirees solely based on investment performance. In years of high performance increases are distributed to retirees in the form of percentage adjustments to the annuity amount. In bad years benefits can be reduced. There is a floor: the benefit being received will never by lower than the initial benefit at the time of retirement.
- Comments: Available materials suggest no stated policy objective beyond a willingness to share a portion of investment gains with retirees, if investment returns permit a distribution. Retiree booklets state that any distributions should not be considered as cost-of-living increases and should not be relied upon.

b. Iowa

- Reported funding ratio: 81%.
- Post-Retirement Procedure. Iowa's procedures vary depending upon when the individual retired. For those retired prior to July 1, 1990, a capped inflation match may be provided if certified by the actuary as being affordable. The increase must not exceed 3%, or the percentage certified by the actuary as affordable.

  For those who retire after June 30, 1990, a different procedure is used. The actuary computes an adjustment factor per year of service, deemed to be affordable for the plan but not to exceed 3%. Any amounts distributed under this system are paid in a lump sum, and are not guaranteed and are not built into the base. The lump sum amount for the individual is computed by multiplying the person's annual benefit by the adjustment factor and by years in retirement.

- Comments: Iowa had been using a capped inflation match, but the newer procedure applicable to those retiring after mid-1990 seems to be a move away from that practice. Under the newer procedure, the increase amounts might not be related to inflation. They may instead be some form of distribution of investment earnings deemed "excessive." In the actuary's summary of plan provisions, distributions under the older procedure are referred to as a capped inflation match, with the added caveat of actuary certification. But adjustments under the newer procedure are referred to as "favorable experience distributions." So under the new procedure distributed amounts may not have a firm tie to inflation and they can be temporarily or permanently discontinued.

c. South Dakota

- Reported Funding Ratio: 96%.
- Post-Retirement Procedure. South Dakota has three separate procedures depending on the plan's health as measured by funding ratios, but the adjustment cannot be less than 2.1%:
  1) If the funding ratio based on market value is less than 80%, a 2.1% increase is paid.
  2) For funding ratios of at least 80% but less than 100%, capped inflation matches with a floor are used. If the funding ratio is at least 80% but less than 90%, the adjustment will match inflation up to 2.4% but must be at least 2.1%. If the funding ratio is at least 90% to less than 100%, the adjustment will match inflation up to 2.8% but must be at least 2.1%.
  3) If the plan has a funding ratio of 100% or more, a 3.1% adjustment is paid regardless of the inflation rate.
- Comments: South Dakota has a combination not currently seen in Minnesota plans, a capped inflation match with a floor. Lacking firsthand knowledge of the situation, we can only speculate on the policy underpinnings for a fixed 3.1% adjustment paid when the funding ratio is at least 100%. Perhaps it is simply based on what is deemed affordable. Perhaps it reflects an estimate of long-term inflation. Another possibility is that it is set at a rate slightly higher than expected long-term inflation, with an intention of compensating for prior years where post-retirement adjustments were less than the inflation rate.

d. Nebraska. Nebraska state and county employees, at least newer employees, do not have access to a defined benefit plan. Their options are between two plans, a defined contribution plan and a cash balance plan. The defined contribution plan is typical, with the employees selecting their own investment options from those made available to them. The cash balance plan could be viewed as a defined contribution plan with a minimum guaranteed return. With the cash balance plan, contributions are deposited in the plan trust and are invested by the state rather than the employee. Guaranteed returns, at the "federal mid-term rate" plus 1.5%, with a floor rate of 5%, are credited to the account. If the actual investment returns are deficient as revealed by an actuarial review, any deficiency is covered by an appropriation. If the review reveals an excess, a special dividend might be allocated to the member accounts.

No true post-retirement adjustment provision is applicable to either of these plans. At the member's request, Nebraska will annuitize the member's account value from the cash balance plan upon retirement, and Nebraska does offer an optional annuity under which benefits will be escalated during retirement by 2.5% per year. But this appears to be an actuarial equivalent annuity form, since there is no other funding source to provide these increases. The annual benefit at retirement will be considerably reduced, then escalated at 2.5% annually. The reductions during the early portion of retirement are computed to be sufficient to cover the excess benefits to be received later in retirement.

Nebraska teachers, and all other employees of school districts, do have a defined benefit plan, and it appears to be the only option other than withdrawal of the account. On the Nebraska government website this is referred to as the School Pension Plan. The plan computes benefits based on the high three average salary and uses 2% accrual rate (benefit multiplier). Post-retirement features of this teacher plan are described below:

- Reported Funding Ratio: 84%.
- Post-Retirement Procedure. The Nebraska School Pension Plan provides an inflation match capped at 2.5%, coupled with a minimum purchasing power guarantee. If the capped inflation match adjustments are insufficient to maintain at least 75% of the retirement benefit's original purchasing power, additional payment is made to bring the individual up to the 75% level.
- Comments: The minimum purchasing power guarantee is an interesting feature we have not found in other plans. It could be used separately, or coupled with a capped inflation match provision, to ensure that no retiree suffers a decline in purchasing power deemed unacceptable by the Legislature.

e. Wyoming. Wyoming recently revised pension plans, with a new plan or Tier being applicable to those starting service after August 2012 or later. Employees who started service earlier are in Tier 1, while the new employees are in Tier 2. Tier 1 employees have a 2.125% accrual rate and are eligible for unreduced retirement at age 60 or upon achieving the Rule of 85 (when years of service plus age equals at least 85). Tier 2 employees have a 2.0% accrual rate, and can retire with full benefits at age 65 or upon attaining the Rule of 85.

- Reported Funding Ratio: 86%.
- Post-Retirement Procedure. No automatic adjustments are provided. The Wyoming Public Employee Pension Plan Handbook includes a statement that the Legislature may grant occasional ad hoc increases, but only if the plan has a funding ratio in excess of 100%, and only if the pension fund, after the increase, remains at least 100% funded.
- Comments: The design of the Wyoming plan or plans can be questioned. The accrual rate, whether for Tier 1 or Tier 2, is above national averages, and the accrual rate is coupled with very low effective retirement age because of the Rule of 85. Individuals who enter public employment at an early age will hit the Rule of 85 while comparatively young. For example, an individual entering covered employment at age 20 could qualify for the Rule of 85 at age 52 and one half. The high benefit payable at a very young age makes the plan expensive. A post-retirement adjustment procedure would provide some protection against benefit erosion during the long expected retirement, but this would further add to cost. Wyoming has chosen to provide no scheduled increases, but this will allow the retiree's purchasing power to seriously erode during retirement. Perhaps the Wyoming legislature views this as an appropriate treatment to remedy a benefit that is too generous at retirement, or to discourage individuals from using the Rule of 85 provision.

f. New York State. New York has many different tiers of employee pension plans, depending upon when the employee began employment. Procedures described here apply to the general employee plan members, Tiers 3 and 4, covering employees who entered the system during the 1976 through 2009 period, and Tier 6, applicable to the newest employees, those who entered service in April 2012 or later.

- Reported Funding Ratio: 94%.
- Post-Retirement Procedure. The percentage adjustment is half the inflation rate, but the adjustment cannot be less than 1% or more than 3%. Also, adjustments apply to only the first $18,000 of annual benefit.
- Comments: New York State plans have several employee tiers, with the applicable tier depending on when the employee started employment. Commission staff reviewed employee booklets for a few of these tiers, and they all appear to use the post-retirement adjustment provision described above.

g. Oregon. Oregon is in a transition phase. Two prior plans were closed to new members, while the new general employees hired since 2003 becoming members of a plan called the Oregon Public Service Retirement Plan (OPSRP). Each OPSRP member is covered by two separate components, a defined benefit plan and an individual account program. Materials on line suggest that the defined benefit component is financed solely by the employer. At retirement, that component will provide benefits not much below those that would be provided by our MSRS-General and PERA-General Plans. Our two plans use a high-five average salary and a 1.7% accrual rate. The Oregon defined benefit component will use a high-three average salary and a 1.5% accrual rate. The other component in the Oregon system is the individual account program. That component is financed by mandatory employee contributions, but it appears that Oregon law will permit those to be instead paid, in whole or part, by the employer. At retirement, the individual will receive the benefit from the defined benefit component plus the value of the account in the individual account program. The value of the two benefits combined is likely to be considerably more than the value of the benefit a comparable individual would receive if the person where in Minnesota public employment, covered by MSRS-General or PERA-General.

The following description, other than the funding ratio which presumably captures both the new defined benefit plan or plans and previous closed plans, applies to the defined benefit component of the OPRSP:

- Reported Funding Ratio: 94%.
- Post-Retirement Procedure. Beginning in 2014, fixed percentage increases will be provided, but different adjustment percentages will apply to different portions of the benefit. A 2% increase will be applied to the first $20,000 of annual benefit. Any benefit amount between $20,001 and $40,000 will be increased by 1.5%. Any benefit amounts between $40,001 and $$60,000 will be increased by 1%. A 0.25% increase will apply to amounts in excess of $60,000.

- Comments: These procedures may be subject to further revision. Since this is a new plan, applicable to 2003 and later hires, these provisions have limited current application because few individuals have retired. Overall, the combined benefits from the defined benefit and individual account program appear generous. The level of that combined benefit may have played a role in deciding to use a specified percentage increase at a fairly low level, rather than an inflation match up to some higher percentage, and the decision to apply very low adjustment percentages to portions of high-value benefits.

h. Utah. Utah is also in a transition phase. General employees hired before July 1, 2011, are in the Tier 1 program, which is a defined benefit plan having a 2% accrual rate (benefit multiplier). New hires since July 2011 are Tier 2 members.

The employee handbook suggests that Tier 2 plans are funded solely by the employer through a 10% of pay contribution. Tier 2 members have a choice between two types of retirement coverage. The first is a hybrid plan and the second is a defined contribution plan. If the defined contribution plan is selected, the employer contributes 10% of pay into that plan on behalf of the employee. If the hybrid plan is selected, the individual's primary coverage is a defined benefit plan with a 1.5% accrual rate. This plan is funded by the employer by a 10% of pay contribution. If the required contribution as determined by the actuary is less than 10%, the residual amount is deposited in a defined contribution account for the member.

- Reported Funding Ratio: 82%.
- Post-Retirement Procedure. For employees covered by the Tier 1 plan, which is a defined benefit plan, the post-retirement adjustment is a 4% capped inflation match. If the employee is covered by the Tier 2 defined benefit plan, the post-retirement adjustment is a 2.5% capped inflation match.

i. Washington State. Washington has separate plans for general employees, depending on whether the employee is a teacher, other school district employee, or other state or local employee. But the plans seem to be quite similar. These Washington plans have similarities to Utah, by having pure defined benefit plans and also hybrid plans which are a combination of a downsized defined benefit plan with a defined contribution component. With the hybrid, the employer finances the defined benefit component while employee contributions finance the defined contribution component.

There are a few differences between the Utah and Washington plans. Nothing in the Washington employee booklets available online suggests that any general employees are covered solely by a defined contribution plan. Also, while new employees in Utah must be covered by the hybrid plan, Washington is headed in the opposite direction. Washington employees hired in the 1996 to 2007 period had mandatory hybrid coverage. Newer employees, however, have the option of pure defined benefit plan coverage or coverage by the hybrid. If no election is made, default coverage is the hybrid. The accrual rate in the pure defined benefit plans is 2% while in the hybrid plans it is 1%.

- Reported Funding Ratio: 82%.
- Post-Retirement Procedure. The post-retirement adjustment procedure for the pure defined benefit plan is a 3% capped inflation match. The post-retirement adjustment procedure for the defined benefit component of the hybrid is the same, a 3% capped inflation match.

j. Delaware. Delaware has a few different plans covering general employees, including one for state employees and another for local and county employees.

- Reported Funding Ratio: 82%.
- Post-Retirement Procedure. For the state employee plan, any post-retirement adjustments are on an ad hoc basis. Commission staff can find no mention of post-retirement increase provisions in the local plan on line plan actuarial report. Presumable none is provided except on an ad hoc basis.
- Comments: Delaware's plans are bare-bones defined benefit plans. The accrual rate in the Delaware state plan is 2% for service before 1997 and 1.85% for service thereafter. The rate for the Delaware local employee plan is 1.66% for all years of service. For comparison, the accrual rate for Minnesota's MSRS-General and PERA-General is 1.7%, while TRA's is 1.7% for pre 2006 service and 1.9% thereafter. So while the Delaware rates are not that different from those in the Minnesota plans, the lack of any post-retirement adjustment provision in the Delaware plans quickly erodes the real value of the Delaware plan benefits.