TO:	Members of the Legislative Commission on Pensions and Retirement
FROM:	Rachel Barth, Deputy Director
RE:	LCPR16-013: SPTRFA; Funding Package Proposal
DATE:	February 8, 2016
ATTACHMENT:	LCPR16-013

Summary of the SPTRFA Funding Package Proposal

Bill draft LCPR16-013 implements the funding package approved by the Board of Trustees of the St. Paul Teachers Retirement Fund Association (SPTRFA).

The bill is intended to address the anticipated funding deficiencies that SPTRFA expects will occur when SPTRFA adopts new mortality assumptions. Since SPTRFA's membership is similar to the membership covered by the Teachers Retirement Association, SPTRFA anticipates that, upon the completion of an experience study in two years, its actuary will recommend changes to its actuarial assumptions similar to those approved by TRA.

The main components of the bills are as follows:

1. <u>Employer Contribution Rate Increases</u>. Section 1 amends Minn. Stat. § 354A.12, subd. 2a, para. (1), by increasing the employer contribution for coordinated members from 6.5% to 7.5% on July 1, 2017, and from 7.5% to 8%[1] on July 1, 2018. Section 2 amends Minn. Stat. § 354A.12, subd. 2a, para. (2), by increasing the employer contribution for basic members[2] from 10% to 11% on July 1, 2017, and from 11% to 11.5%[3] on July 1, 2018.

2. <u>Postretirement Adjustment Revisions</u>. Section 2 also amends Minn. Stat. § 354A.29, subd. 7, by retaining the current 1% postretirement adjustment (COLA) and removing the COLA triggers that permitted a COLA of:

   - 2% if the plan's funding ratio is at least 80% but less than 90% on an actuarial value of assets for two consecutive actuarial valuations, and
   - 2.5% if the plan's funding ratio is at least 90% on an actuarial value of assets for two consecutive actuarial valuations.

All provisions are effective July 1, 2016.

[1] This percentage does not include a supplemental 3.84% employer contribution.
[2] As of July 1, 2015, there are only 5 active basic employees.
[3] This percentage does not include a supplemental 3.64% employer contribution.

Background Information

The proposed legislation is intended to mitigate SPTRFA's anticipated funding deficiency that will result if SPTRFA's board of trustees approves the same or similar changes to the mortality assumptions adopted by the boards of MSRS, PERA, and TRA, as a result of their respective experience studies. Although SPTRFA will not have a completed experience study for another two years, St. Paul teachers are in the same demographic pool as members of TRA and therefore the plan expects that its members, like TRA members, are living on average two years longer than assumed.

To determine the potential financial impact of changing the mortality assumptions, SPTRFA's actuary applied the same mortality tables recently adopted by the TRA board, RP-2014 mortality table, to the 2015 actuarial valuation data and compared those results to the actual 2015 actuarial valuation. On an actuarial value of assets, SPTFRA's funding ratio dropped from 62.6% to 60.6% and the plan's funding deficiency dropped from 1.6% to 3.10%. On a market value of assets, the plan's funding ratio dropped from 63.6% to 61.6% and the funding deficiency dropped from 1.28% to 2.77%. The actuarial accrued liability increased from $1.596 to $1.648 billion.

No data has been presented regarding the impact of new mortality assumptions on achieving the COLA triggers. However, in the plan's current 2015 actuarial valuation, the expected date on which the COLA would increase from 1% to 2% is 2041 and then increase from 2% to 2.5% is 2051. If the COLA trigger dates were determined after applying the new morality assumptions, it is reasonable to assume that the COLA increase dates to 2% and then to 2.5% would occur after 2041 and 2051, respectively.

The SPTRFA board approved a comprehensive funding package that attempts to proactively respond to the anticipated impact of new mortality assumptions that SPTRFA has not adopted yet but likely will adopt when its experience study is complete. The proposed legislation increases funding by raising the employer contribution rate, leaving the employee contribution rate unchanged. Under current law, SPTRFA has phased in increases in the employer contribution rate for coordinated members: effective as of July 1, 2015, the rate is 6%, and will automatically increase to 6.25% on July 1, 2016, and to 6.5% on July 1, 2017. The proposed legislation will increase the employer contribution rate on July 1, 2017, from 6.5% to 7.5% and add a rate increase on July 1, 2018, of 8%, resulting in a combined total employer contribution increase of 1.5%, phased-in over two years. The employer contribution rate for basic members will also increase by a combined 1.5% by July 1, 2018, phased-in over two years, but there are only five basic members still active, so those rate increases will not be a substantial funding source. The proposed legislation permanently sets the COLA at 1% and removes the COLA triggers. The combination of the removal of the COLA triggers and the increased contributions is expected to eliminate the funding deficiency caused by the new mortality assumptions.

Policy Considerations

Bill draft LCPR12-013 raises the following pension and public policy issues:

1. <u>Cost and Equity.</u> The proposed funding package is projected to cover the anticipated deficiencies caused by the adoption of new mortality assumptions. SPTRFA reduced its interest rate assumption from 8.5% to 8% last session, so the effects of that reduction were recognized in the plan's 2015 actuarial valuation.

As of July 1, 2015, based on the market value of assets of $1,015 million, the funded status of the plan is as follows:

Actuarial accrued liability:	$1,596.8 million
Unfunded actuarial accrued liability:	$581.8 million
Funded ratio:	63.56%
Statutory contribution rate:	20.66% of pay
Required contribution rate:	21.94% of pay
Deficiency:	1.28% of pay
Deficiency based on ultimate contribution rates:	0.28% of pay

This funding status and contribution deficiency can be expected to worsen upon the adoption of new mortality assumptions.

The proposed legislation increases employer contributions for both coordinated and basic members by amending the contribution increases already in statute to result in total employer contribution increases of 1.5% for each employee group by July 1, 2018. Ignoring the supplemental contribution, currently, the St. Paul school district contributes 6% of pay, which is less than both TRA and PERA-General employers. Employees currently contribute 7%, which is more than MSRS-General and PERA-General, and less than TRA, although when the automatic increase to 7.5% takes effect on July 1, 2016, SPTRFA's employee contribution will be the same as TRA. Under the proposed legislation, the St. Paul school district's contribution will increase to 8% on July 1, 2018, which will be more than the employer contribution is currently compared to MSRS-General, PERA-General, and TRA, assuming no change in their employer contributions. The 1.5% employer contribution increase will cost the St. Paul school district an additional approximately $3.9 million annually, when the increase is fully effective on July 1, 2018.

The proposed legislation also decreases costs by permanently setting the COLA at 1% and removing the COLA triggers. By just removing the COLA triggers, the plan's funding deficiency will decrease by 0.6%. Keeping the COLA at 1% will not have an immediate impact on retirees because they are currently receiving a 1% COLA and based on the 2015 actuarial valuation which estimated that the COLA would not increase to 2% until 2041 and 2.5% until 2051, most retirees will not live long enough to see the increases. If all assumptions in the 2015 actuarial valuation were to actually occur, current employees would likely receive the COLA increases, but it is reasonable to assume that the new mortality assumptions would have pushed the COLA increase dates even further out.

2. Unintended Consequences of the COLA Triggers. Eliminating the COLA triggers, which determine when the COLA will increase to 2% and eventually to 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 SPTRFA were to address the anticipated increase of the 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, SPTRFA'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.

Removing the triggers means that they do not have to be valued by the actuary in determining contribution deficiency or sufficiency and funded status. Moreover, removing the triggers does not mean that a higher COLA could not be approved in the future if the plan's funded status improves to 80% or 90% or if higher rates of inflation return. The intent behind a COLA 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. As noted, removing the triggers does not mean that the COLA could never be increased in the future if and when higher rates of inflation return, but does mean that the plan will not have to fund currently a possible increase in the COLA many years from now.

3. <u>Appropriate Timing and Scope of Proposal.</u> The proposed legislation is in response to anticipated changes in the plan's actuarial assumptions for mortality. These assumption changes have not yet been approved by the SPTRFA board of trustees. The boards of MSRS, PERA and TRA recently approved changes in their mortality assumptions, based on experience studies completed for those plans, which indicated that mortality rates have increased. As a result, SPTRFA anticipates that it will need to change its assumptions for mortality, following the completion of its own experience study in two years, but no assumption changes have yet been approved.

   The impact on SPTRFA when it changes the actuarial assumptions for mortality is estimated to be significant, but the need for immediate action is not as clear as in the case of MSRS, PERA and TRA, which have already approved the use of the new mortality tables. As noted, SPTRFA has not yet approved use of the new tables, so while the plan is experiencing the fact and cost of members living longer, the actuarial valuation does not reflect the impact of increased mortality lives in valuing future liability.

   SPTRFA's experience study could recommend additional assumption changes that may have an impact on the plan and would require SPTRFA to come back in two years with a new funding proposal, so the proposed legislation may be premature. On the other hand, St. Paul teachers are in the same demographic pool as TRA teachers, so the rise in longevity seen among TRA members is likely to be seen among SPTRFA members. So, if no action is taken, the plan may not be properly funding all of its liabilities that will eventually be recognized when the plan adopts the new mortality assumptions.

   No action could leave the fund in a vulnerable position. The investment returns have been low and if that pattern continues, the plan's deficiencies will be even larger when it eventually adopts the new mortality assumptions. Further, mortality rates are only expected to improve. The impact of the new mortality tables is 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 Commission's actuary, Deloitte, and SPTRFA's actuary, in its report on the experience studies for MSRS and PERA, recommended the interest assumption rate should be between 7 to 8%, suggesting a lower rate will eventually need to be considered.