TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Rachel Barth, Deputy Director

RE: S.F. 1064 (Rosen); H.F. 1288 (O'Driscoll): MSRS; Funding Proposal Bill

DATE: February 17, 2017

Summary of S.F. 1064 (Rosen); H.F. 1288 (O'Driscoll)

S.F. 1064 (Rosen); H.F. 1288 (O'Driscoll) is the Minnesota State Retirement System (MSRS) board-approved funding proposal that includes revisions to the General, Correctional, State Patrol, and Judges plans. The components of the proposal are described below, section by section.

MSRS FUNDING PROPOSAL

The MSRS funding proposal includes employee and employer contribution rate increases and removing the postretirement adjustment ("COLA") triggers for the General, Correctional and State Patrol plan and also reduces the investment return assumption and lowers the interest rate used for certain payments for all MSRS pension plans.

The Unclassified plan employee contribution rate, which is set to always equal the MSRS-General employee contribution rate, will also increase. The employer contribution rate, which is currently set at 6%, will not increase.

The funding proposal prospectively lowers the COLA for the General and Correctional plans.

The proposal attempts to improve the plans' funding and maintain solvency as a result of changes to member mortality, lower investment returns, and lowering the investment return assumption.

	2016 Actuarial Valuation[1]		Impact of Proposal [2]	
	Funding Ratio	Contribution Sufficiency/(Deficiency)	Funding Ratio[3]	Contribution Sufficiency/(Deficiency)
General	78.4%	(4.5%)	91.4%	(0.4%)
Correctional	68.5%	(6.7%)	101.9%	0%
State Patrol	75.6%	(5.5%)	96.7%	0%

<u>**Sections 4, 10 & 15**</u> – ***Employee Contribution Rate Increases.***

	General &Unclassified Plan Employee Contribution Rate Increases					
	Current Rate	FY18	FY19	FY20	FY21	Total
Increase		0.5%	---	---	---	0.5%
Rate	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%

	Correctional Plan Employee Contribution Rate Increases					
	Current Rate	FY18	FY19	FY20	FY21	Total
Increase		0.5%	---	---	---	0.5%
Rate	9.1%	9.6%	9.6%	9.6%	9.6%	9.6%

[1] On a market value of assets.
[2] Source: MSRS presentation to House Governmental Operations Committee Jan. 18, 2016.
[3] As of 2044.

	State Patrol Plan Employee Contribution Rate Increases					
	Current Rate	FY18	FY19	FY20	FY21	Total
Increase		0.5%	---	0.5%	---	1.0%
Rate	14.4%	14.9%	14.9%	15.4%	15.4%	15.4%

The combination of increased longevity, lower investment returns, and reducing the investment return assumption results in increased plan liabilities. Therefore, there is an equity argument that supports an increase in employee contribution rates to pay for a portion of these new liabilities.

However, a significant portion of the plan's liabilities were not accrued by current employees. Therefore, to maintain generational equity, current employees should not be required to pay for past employee and retiree liabilities. Further, current employees fund a larger portion of their retirement benefit because a large portion of the employers' contributions are used to pay off the unfunded liability. An equity issue arises when an employee is required to contribute even more to a benefit that does not increase in value.

Section 5, 11, 12 & 16 – ***Employer Contribution Rate Increases.***

General Plan Employer Contribution Rate Increases						
	Current Rate	FY18	FY19	FY20	FY21	Total
Increase		1.5%	---	1.0%	---	2.5%
Total Rate	5.5%	7.0%	7.0%	8.0%	8.0%	8.0%

Cost of Contribution Increases Assuming 0% Payroll Growth					
	FY18	FY19	FY20	FY21	Total
Increase	1.5%	---	1.0%	---	2.5%
Cost	$43.3M	$43.3M	$72.2M	$72.2M	$231M

Cost of Contribution Increases Assuming 2.5% Payroll Growth					
	FY18	FY19	FY20	FY21	Total
Increase	1.5%	---	1.0%	---	2.5%
Cost	$44.4M	$45.5M	$77.8M	$79.7M	$247.4M

Correctional Plan Employer Contribution Rate Increases						
	Current Rate	FY18	FY19	FY20	FY21	Total
Regular Rate Increase	12.85%	1.55%	---	---	---	1.55%
Supplemental Rate Increase	---	4.45%	---	---	---	4.45%
Total Rate	12.85%	18.85%	18.85%	18.85%	18.85%	18.85%

Cost of Contribution Increases Assuming 0% Payroll Growth					
	FY18	FY19	FY20	FY21	Total
Total Increase[4]	6.0%	---	---	---	6.0%
Cost	$14.9M	$14.9M	$14.9M	$14.9M	$59.6

Cost of Contribution Increases Assuming 2.5% Payroll Growth					
	FY18	FY19	FY20	FY21	Total
Total Increase	6.0%	---	---	---	6.0%
Cost	$15.2M	$15.6M	$16M	$16.4M	$63.2M

State Patrol Plan Employer Contribution Rate Increases						
	Current Rate	FY18	FY19	FY20	FY21	Total
Regular Rate Increase	---	0.75%	---	0.75%	---	1.5%
Supplemental Rate Increase	---	7.0%	---	---	---	7.0%
Total Rate	21.6%	29.35%	29.35%	30.1%	30.1%	30.1%

[4] Combination of employer regular and supplemental rate increases.

State Patrol Plan Employer Contribution Rate Increases

Cost of Contribution Increases Assuming 0% Payroll Growth					
	FY18	FY19	FY20	FY20	Total
Total Increase	7.75%	---	0.75%	---	8.5%
Cost	$5.7M	$5.7M	$6.2M	$6.2M	$23.8M

Cost of Contribution Increases Assuming 2.5% Payroll Growth					
	FY18	FY19	FY20	FY21	Total
Total Increase	7.75%	---	0.75%	---	8.5%
Cost	$5.8M	$5.9M	$6.7M	$6.9M	$25.3M

Traditionally, the employer and employee contribution rates for the General plan have been equal and the public safety plan rates have been split so that employees cover 40% and employers cover 60% of the cost. The proposals deviate from these past practices by increasing the employer contribution rates more. This split from tradition attempts to maintain generational equity by not requiring current employees to pay for past liabilities and retiree costs. The increased employer contributions will help fund the plans' normal cost and a larger portion of the unfunded liability.

All three plans added provisions that reduce the employer contribution rate in the future if certain funding requirements are met. For the General plan, the employer contribution rate must decrease to be equal to the employee contribution if the General plan ever reaches a 100% funding ratio on a market value of assets. For the Correctional and State Patrol plans, the new supplemental contributions must expire when the respective plan reaches a 100% funding ratio on a market value of assets.

<u>Unclassified Plan Impact</u>

The difference between the General and Unclassified plan employer contribution rates could cause issues in the future. The Unclassified plan is a defined contribution plan, but members have two options: (1) convert their Unclassified account into a General plan annuity at a statutorily determined time during their career; or (2) purchase an annuity from MSRS using their Unclassified account.

If the member elects the first option, the General plan annuity is calculated using the formula of years of service x high-5 average salary x accrual rate (1.7%). The amount of money in the Unclassified account does not impact the annuity calculation. The statute states that if the Unclassified employee contribution rate was lower at any point in the past than the General plan employee contribution rate, the employee must make up the difference. However, the statute does not specify what happens if the Unclassified employer contribution rate was lower, so it is assumed that the employer does not pay the difference and that the General plan subsidizes the difference.

The issue that needs to be resolved is how to keep the General plan from subsidizing a larger portion of the annuity due to the differences in employer contribution rates. The Unclassified employer contribution rate will remain at 6%, but the current proposal increases the General plan employer contribution rate to 8%. That leaves a 2% difference. MSRS should consider whether the employer will have to pay a lump-sum equal to the 2% difference in employer contribution rates if an employee elects the General plan or if the General plan will end up subsidizing a larger portion of the annuity.

<u>Section 23</u> – ***Investment Return Assumption Decrease.***

The proposal lowers the investment return assumption from the current 8.0% to 7.5% as of July 1, 2017 for the General, Correctional, State Patrol, and Judges plans.

The decision to lower the assumption was based on the State Board of Investment's Asset Liability Study that estimates an average 7.3% return over the next 10 years, the national trend towards lowering the assumption, and the MSRS actuary's statement in the 2016 Actuarial Valuations that an 8.0% assumption may be deemed unreasonable for future valuations due to declining capital markets and inflation.

Lowering the investment return rate reduces risk in a volatile market but results in a significant increase in liabilities for each plan. If the investment return rate is lowered, but no plan changes occur, the General, Correctional, and State Patrol plans will experience significant decreases in their funding ratios by 2044.

<u>Section 24</u> – ***Resetting the Amortization Period.***

The proposal resets the 30-year amortization period for the General, Correctional, State Patrol, and Judges plans.

	Amortization Date	
	Current	Proposed
General Plan	2043	2047
Correctional	2039	2047
State Patrol	2039	2047
Judges	2039	2047

Resetting the amortization period merely spreads out the current liability over a longer period of time. This results in today's employees paying off old liabilities that they did not accrue. Under the principle of generational equity, current employees should be paying for their own liabilities. Another option would be to keep the current amortization date and look to other possibilities and options to reduce plan liabilities.

<u>Section 25</u> – ***Lowering the General and Correctional plan COLAs.***

The proposal prospectively lowers the COLA from 2.0% to 1.5% on January 1, 2018, for the General and Correctional plans.

There is inconsistency among MSRS plans regarding the COLA. State Patrol retirees currently receive a 1.0% COLA, which is why the plan is not proposing to lower the COLA. There does not appear to be a compelling policy reason for the inconsistency in COLA amounts. It would be more equitable and consistent if all MSRS plans received the same COLA.

Further, the intent behind the COLA is to protect the retirement benefit from inflation. Inflation rates are currently at historic lows. The COLA could be lowered further for the General and Correctional plans to better reflect current inflation rates and to be more in accordance with the intent behind COLAs.

<u>Sections 25 & 26</u> – *Removing the COLA Triggers*

The proposal removes the COLA triggers, which determine when the COLA will increase to the maximum 2.5%.

The triggers result in a funding problem. When the actuary determines the contributions needed to get the respective 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 the triggers are not removed, any additional money going into the plan would speed up the attainment of the trigger and fund the COLA increase rather than the plan's liabilities.

<u>Section 27</u> – *Clarifying Language to Maintain Judges Plan COLA Triggers*

The Judges plan is keeping the COLA triggers, so language was added to maintain the trigger mechanisms.

<u>Sections 1-3, 6-9, 13, 14, 17-22, & 28-31</u> – *Revising Interest Rates*.

There are provisions throughout the bill that update the interest rate used for payments, such as refunds, omitted contributions etc. Interest rates used for such payments have always aligned with the investment return rate used during a certain period of time.