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| TO: | Members of the Legislative Commission on Pensions and Retirement |
| FROM: | Rachel Barth, Deputy Director |
| RE: | H.F. xxxx; S.F. xxxx (LCPR17-007): PERA; Funding Proposal Bill |
| DATE: | February 6, 2017 |

**Summary of H.F. xxxx; S.F. xxxx (LCPR17-007)**

LCPR17-007 Is the Public Employees Retirement Association (PERA) board-approved funding proposal that includes revisions to the General and Police and Fire, and Correctional plans. The components of the proposal are described below, section by section.

**PERA FUNDING PROPOSAL**

The PERA funding proposal includes employee and employer contribution rate increases, removing the postretirement adjustment ("COLA") triggers, and resetting the amortization period for the Police and Fire plan.

The funding proposal reduces the investment return assumption and lowers the interest rate used for certain payments for Police and Fire, 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 | 72% | (1.87%) | 84% | (3.5%) |
| Police & Fire | 84% | (0.9%) | 89% | (0.7%) |

<u>**Sections 11**</u> – ***Employee Contribution Rate Increases.***

| | Police & Fire Employee Contribution Rate Increases | | | | | |
|---|---|---|---|---|---|---|
| | Current Rate | FY18 | FY19 | FY20 | FY21 | Total |
| Increase | | 0.5% | 0.5% | --- | --- | 1.0% |
| Rate | 10.8% | 11.3% | 11.8% | 11.8% | 11.8% | 11.8% |

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.

[1] On a market value of assets.
[2] Source: PERA presentation to House Governmental Operations Committee Jan. 18, 2016.
[3] As of 2046.

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 the employee is required to contribute even more to a benefit that does not increase in value.

**<u>Section 12</u>** – ***Employer Contribution Rate Increases.***

| | **Police & Fire Employer Contribution Rate Increases** | | | | | |
|---|---|---|---|---|---|---|
| | Current Rate | FY18 | FY19 | FY20 | FY21 | Total |
| Increase | | 0.75% | 0.75% | --- | --- | 1.5% |
| Rate | 16.2% | 16.95% | 17.7% | 17.7% | 17.7% | 17.7% |

| Cost of Contribution Increases Assuming **0% Payroll Growth** | | | | | |
|---|---|---|---|---|---|
| | FY18 | FY19 | FY20 | FY21 | Total |
| Increase | 0.75% | 0.75% | --- | --- | 1.5% |
| Cost | $3.3M | $9.8M | $13M | $13M | $39M |

| Cost of Contribution Increases Assuming **2.5% Payroll Growth** | | | | | |
|---|---|---|---|---|---|
| | FY18 | FY19 | FY20 | FY21 | Total |
| Increase | 0.75% | 0.75% | --- | --- | 1.5% |
| Cost | $3.4M | $10.5M | $14.4M | $14.7M | $43M |

Traditionally, the Police & Fire employer and employee contribution rates have been split so that employees cover 40% and employers cover 60% of the cost. The proposal deviates from this past practice 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 fund the plans' normal cost and a larger portion of the unfunded liability.

**<u>Section 13</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, Police and Fire, and Correctional 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 plans' actuary stated 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. The General plan did not experience a significant decrease in its funding ratio as a result of the lower investment return rate, so the PERA board decided not to make any other plan changes. However, for the Police and Fire plan, if the investment return rate is lowered, but no plan changes occur, the plans will experience significant decreases in its funding ratios by 2046.

**<u>Section 14</u>** ***– Updating Mortality Assumption Components***

The proposal includes updated language for how the mortality assumption can be changed and what components must be included in the assumption. The methodology for determining the appropriate mortality assumption has changed over the past few years and this language reflects the newest methodology.

**<u>Section 15</u>** – ***Resetting the Amortization Period.***

The proposal resets the Police and Fire plan's 30-year amortization period from 2041 to 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 for lowering plan liabilities.

**<u>Section 16</u>** ***– Clarifying Language to Maintain PERA General and Correctional Plan COLA Triggers***

The General and Correctional plans are keeping the COLA triggers, so the proposal adds language to maintain the trigger mechanisms.

**<u>Section 17</u>** ***– Removing the Police & Fire COLA Triggers***

The proposal removes the Police and Fire 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.

If this provision is enacted, there will be an inconsistency among PERA plans regarding the COLA trigger. PERA's other two plans, General and Correctional, are not removing the COLA triggers. Due to the challenge the triggers present to funding and to remain equitable among plans, it would be more consistent to remove the trigger for all PERA plans.

**<u>Sections 1-10 &18</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.