TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Susan Lenczewski, Executive Director

RE: S.F. xxxx; H.F. 722 (Murphy, M.): TRA; Funding Bill Proposal

DATE: February 6, 2017

Summary of S.F. xxxx; H.F. 722 (Murphy, M.)

H.F. No. 722 is the bill that sets forth the employer contribution and post-retirement adjustment modifications, among other changes, proposed by the Teachers Retirement Association ("TRA"). The proposal was approved by the TRA board of trustees at its meeting on December 14, 2016. The proposal is intended to respond to:

- The increase in plan liabilities due to changes in actuarial assumptions, including mortality;
- The anticipated increase in liabilities when the plan's investment rate of return assumption is reduced from the current 8.5%; and
- Lower actual investment rates of return, in the last couple years, as compared to the assumed rate of return.

The following is a summary of the bill and policy considerations.

Current Status

As reported in TRA's actuarial valuation report as of July 1, 2016, issued by the actuarial firm, Cavanaugh MacDonald Consulting LLC:

	July 1, 2016 Valuation Results	July 1, 2015 Valuation Results
Total Required Contribution Rate	18.7%	17.9%
Statutory Contribution Rate	15.9%	16%
Sufficiency/(Deficiency)	(2.8%)	(1.9%)
Unfunded Actuarial Accrued Liability ($Billions)	$6.5	$5.9
Funded Ratio (Actuarial Assets)	75.6%	77%

<u>Section 1</u>: *Pension Adjustment Revenue*

The allocation of general education revenue is set forth in Minnesota Statute § 126C.10. General education revenue is allocated among a number of categories, including, to name just a few, basic revenue, gifted and talented revenue, declining enrollment revenue, small schools revenue, and pension adjustment revenue. The proposed change is to the method for determining the amount of the pension adjustment revenue for each school district. The change adds to the amount of pension adjustment revenue described in current law for each school district an amount representing the proposed increases in employer contributions to TRA and the St. Paul Teachers Retirement Fund Association so that the amount each district receives will keep pace with the proposed increases.

We understand that this shifts the financial burden of the proposed employer contribution increases from the school districts to the state.

<u>Section 2</u>: ***Employer Contribution Rate Increases***

	Current	FY18	FY19	FY20	FY21	Total
Increase		0.5%	0.5%	0.5%	0.5%	2.0%
Rate	7.5%	8%	8.5%	9%	9.5%	8.0%

Cost of Contribution Increases Assuming 0% Payroll Growth					
	FY18	FY19	FY20	FY21	Total
Increase	0.5%	0.5	0.5	0.5	2.0%
Cost	$22.6M	$45.2M	$67.7M	$90.3M	$158.1M

Cost of Contribution Increases Assuming 2.5% Payroll Growth					
	FY18	FY19	FY20	FY21	Total
Increase	0.5%	0.5	0.5	0.5	2.0%
Cost	$23.7M	$48.6M	$74.7M	$102M	$176.7M

TRA is proposing to increase the employer contribution rate by .5% each year, for the next four fiscal years, starting with the fiscal year beginning July 1, 2017.

According to TRA's actuarial valuation report as of July 1, 2016, TRA's assets are $6.5 billion less than its liabilities and its funded ratio is 75.6% and trending downward. As explained by Deloitte Consulting, the Pension Commission's actuary, at the Commission meeting last week, there are two options for addressing a funding shortfall:

- increase the dollars going into the fund, and/or
- decrease the dollars going out of the fund.

More dollars can come from any of three sources: more employer contributions (from school districts or direct state aid), more employee contributions or better investment returns. Of these three options, TRA has no influence over investment returns, but it can propose increases to either or both employee and employer contributions. TRA's proposal includes only increases in employer contributions.

As for decreasing the dollars being paid by the fund, there is an array of benefits that could be modified to achieve cost savings. In Section 10, described below, TRA proposes to modify only one benefit, the post-retirement adjustment, or COLA, which is roughly a cost of living adjustment to the pensions being paid to retirees.

<u>Section 3</u>: ***Employer Contributions for Reemployed Retirees***

When a retiree returns to service covered by TRA, current law provides that a portion of the annuity being paid to the retiree is suspended and retained in an account and eventually paid to the retiree. The portion of the annuity suspended is deducted from the annuity payable for the calendar year immediately following the fiscal year in which salary earned from the reemployment exceeds $46,000. The amount suspended from the annuity is equal to 50% of the salary received in excess of $46,000.

One year after the reemployment suspension period ends, the retiree can receive a lump sum payment of the amount suspended plus interest. During the period of reemployment, the retiree does not earn additional service credit, employee contributions are not required, nor is the school district required to make employer contributions with respect to the reemployed retiree. Once a retiree reaches normal retirement age, the benefit suspension requirement no longer applies.

TRA's bill modifies the reemployed retiree provisions by adding the requirement that employer contributions are required with respect to the reemployed retiree. Under this proposal, TRA would receive additional employer contributions without incurring any corresponding additional liabilities. Employer contributions will be paid into the fund, but the retiree will receive no benefit from those contributions because the retiree does not earn any additional service or salary credit for the period of reemployment.

From the school district's perspective, under current law, there is an incentive to hire retirees rather than non-retirees, because in the case of a retiree, the district does not have to pay employer contributions. The proposed change eliminates that incentive.

Since no other aspects of the reemployed retiree's situation changes, it appears that this change is being made to increase employer contributions being paid to TRA.

Sections 4-7, 11: *Interest Rate on Payments, Refunds, Shortages*

TRA and the other plans pay interest or are paid interest on many different types of payments. For TRA, such payments include payments made by rehired members when they repay a previous refund, payments by the school district when they fail to deduct enough from an employee's paycheck (a "shortage"), and late payment of employer contributions by a school district. The other plans' rate of interest is tied to the investment rate of return assumption. With the lowering of that assumption, all statutory references to interest rates had to be revised. Rather than make that change in numerous places throughout the statutes, a reference to a new section, Minnesota Statute § 356.59, has been inserted to replace specific references to rates of interest. The new statute is added by Section 11 of the bill, and is a compilation of all the interest rates over different time periods for each of the plans.

TRA is not tying its interest rate to changes in the investment rate of return assumption, but will continue to charge 8.5% interest on all payments. Therefore, the provision for TRA in the new statute at Section 11 reflects only one interest rate for TRA. Not lowering the rate to mirror the investment return assumption means that TRA will collect a net increase in interest paid to the fund.

Section 8: *Decrease in Assumption for Investment Rate of Return*

TRA is proposing to reduce the assumption for investment rate of return from the current 8.5% to 7.5% for five years, beginning July 1, 2017, until June 30, 2022, followed by an increase in the rate of return assumption to 8% beginning on July 1, 2022.

TRA has decided to lower the rate by 1% for five years to give it time to conduct a study to determine the appropriate rate of return. TRA's proposal differs from MSRS, TRA and St. Paul Teachers in that they all are proposing to reduce their assumption to 7.5%, effective July 1, 2017, with no future increase.

Whatever is ultimately decided by the Pension Commission and the Legislature with respect to the investment rate of return assumption, there is reason to think the assumption should be the same for all the

plans. All the public pension plans' assets are commingled and invested in the same way by the State Board of Investment. TRA's assets are not invested differently than the other plans' assets so there is nothing to suggest their assets will achieve a different rate of return than the rest of the assets invested by the SBI.

We understand that for actuarial purposes, having two investment rate of return assumptions for different periods means that the rates will be blended to result in a rate of return slightly less than 8%. This will understate TRA's funding status, as compared to the other plans that will be using a single rate of 7.5%.

Section 8 also makes changes to paragraph (b) of Minnesota Statute § 356.215, subdivision 8, to eliminate references to the COLA triggers for purposes of performing actuarial valuations. See Section 10, below, which proposes changes to remove the COLA triggers.

Section 9: *Resetting the Amortization Period*

TRA proposes to reset the amortization period from 2037 to 2047, extending the period by 10 years.

Resetting the amortization period lengthens the period over which the plan's current liability will be amortized or paid off. Current and future employees' contributions will be used for an additional 10 years to pay off liabilities accrued to date, that should be paid off by 2037 under current law. This runs counter to the principle of generational equity, if that is a principle the Commission wishes to support.

For some time, amounts going into the plan failed to keep pace with annual benefit accruals and pension payments to retirees, resulting in an ever-increasing funding shortfall. Lengthening the amortization period masks this problem. The analogy used to illustrate this situation is a mortgage refinancing. Refinancing does not reduce the remaining debt, but serves only to stretch out the repayment period and, thereby, reduce the annual installments. An option to extending the amortization period is to keep the current amortization date and look at ways to reduce plan liabilities.

Section 10: *Reducing the Post-Retirement Adjustment Rate ("COLAs")*

As mentioned above, a post-retirement adjustment, or COLA, is an annual adjustment that increases the pension being paid to retirees to roughly approximate increases in the cost of living. TRA is proposing to reduce the COLA rate from 2% to 1% effective January 1, 2018, until December 31, 2022. Effective January 1, 2022, TRA proposes to increase the rate from 1% to 1.5%.

There is inconsistency among the plans regarding the COLA. MSRS is reducing the rate from 2% to 1.5% effective January 1, 2018, with no future increase. PERA and St. Paul Teachers pay a 1% COLA. There does not appear to be a compelling policy reason for the inconsistency in COLA rates. If uniformity among the plans continues to be a principle the Commission supports, all plans should have the same COLA rate.

Further, the intent behind a post-retirement adjustment is to protect the value of the monthly stream of pension payments. If inflation raises the cost of living, then the theory is that the pension should be increased by a similar rate. The rate of Inflation is at historic lows. The COLA could be lowered further to match inflation or modified to automatically adjust as an inflation index, such as CPI-U, adjusts.

Section 10, along with the subdivision being repealed in Section 12, also eliminates the so-called "COLA trigger." The trigger is an automatic increase in the post-retirement adjustment rate when a funding threshold is reached. For TRA, when the plan's funding ratio equals or exceeds 90% for two years, the

COLA is increased to 2.5%. The COLA will decrease to 2% if the funding ratio equals or is less than 85% for two years or 80% for one year.

The trigger results in a funding problem, because when the actuary determines the funding status and the contributions needed to fund the annual cost of benefit accruals, the actuary must take into account the estimated date of reaching the trigger and the resulting increase in the COLA. As a result, the better funded the plan becomes and the closer it is to 90% funded, the more the liability increases because the COLA increase date is getting closer. This circular effect is confusing and could result in a disincentive to take measures to improve the plan's funding ratio.

Section 12: ***COLA Triggers***

This section repeals subdivision 1 of Minnesota Statute § 356.415, which is one of several subdivisions that describes the COLA triggers.