South Dakota Retirement System

Evolving Benefits and Sustainability

For Presentation at the ASBSD/SASD Convention
August 11, 2017

SDRS Basics

- A consolidated cost sharing, multiple employer, defined benefit retirement system created in 1974
- Covers essentially all South Dakota public employees
- Typical defined benefit design with expanded hybrid and variable benefit features
- Fixed, statutory contribution rates since inception
- South Dakota Law requires board recommendations for benefit reductions or other corrective actions if funding thresholds crossed
- Numerous pre-funded, benefit improvements prior to 2008
- Benefit reductions in 2010 after great recession and in 2017 related to actuarial assumption changes (primarily future COLA adjustments)

SDRS Environment

- SDRS has been well funded for the last 30 years
- The South Dakota Investment Council invests SDRS funds and has an outstanding long-term performance record
- Fixed, statutory contribution rates have never been adjusted because of plan experience
- Contribution rates are comparatively modest:
  - 6% of pay for both employer and member, for most members
  - median employer contribution rate for statewide retirement plans is 13%
- Initial benefits were also modest and have been improved over the years to meet specific Board of Trustee goals

Governance

- Board of Trustees oversees SDRS – primarily elected representatives of employees and employers
- Board assumes fiduciary responsibility for management of SDRS, making policy recommendations to meet funding goals, and initiating legislation
- Bipartisan standing legislative committees review all legislation pertaining to retirement issues – almost always only after input and recommendations from the Board
- Board has established specific and measurable benefit and funding objectives and a strategic plan to guide the management of SDRS
- Changes to SDRS are typically made only with broad consensus

South Dakota Perspective: Benefit Policy

- A defined benefit plan is preferred because it is the most efficient and advantageous design for members, employers, and taxpayers
- Hybrid features that combine the advantages of both defined benefit and defined contribution plans are essential for an equitable distribution of benefits to both career and non-career members
- Variable benefits based on affordability measures are essential for sustainability and the COLA is the most logical benefit feature to vary
- Benefits should meet specific income replacement objectives; excessive benefits must be avoided
- Provisions and practices that result in higher than intended and/or artificially inflated benefits must be avoided and corrected to protect scarce resources and to reinforce adherence to our goals

South Dakota Perspective: Governance and Plan Management

- The SDRS Board of Trustees must have the expertise, knowledge, and resources and act as fiduciaries, to recommend benefit and funding policies, and to actively lead SDRS
- Fixed contributions are a prudent financial decision, and SDRS benefits must be managed accordingly since:
  - Variable contributions may require significant and unpredictable higher costs
  - Contribution increases alone are not adequate to solve funding issues for mature plans
  - If costs are not controlled, SDRS will be replaced by a defined contribution plan
- A realistic planning horizon for mature systems like SDRS is 10-20 years because of the duration of our liabilities

South Dakota Perspective: Funding Policy

- The SDRS funding policy must specify minimum funding standards to dictate when changes are required or should be considered
- Reliance on our long-term past investment results exclusively is not realistic
- Future mortality improvement must be considered in actuarial assumptions
- Actuarial methods and funding policies that result in expected increasing unfunded liabilities (referred to as negative amortization) are unacceptable

South Dakota Perspective: Funding Policy

- Contribution rates with a 50% chance of funding actuarial liabilities are not acceptable unless accompanied with flexible benefits
- Recommendations for corrective actions are required under Law if the fixed, statutory contributions are not sufficient to meet the actuarial requirement or the Fair Value Funded Ratio (FVFR) is less than 100%
- Additional risk measures must be developed and communicated to provide transparent disclosure of the likelihood of meeting the funding policies and benefit goals of SDRS

SDRS Funded Status

- SDRS has been 100% funded or more based on fair value of assets in all but five years since 1986
- SDRS' FVFR:
  - Was 97% at June 30, 2016
  - Will be 100% at June 30, 2017 after strengthening of actuarial assumptions in 2012, 2014 and 2017
- SDRS has no unfunded liability or balance sheet liability
- However, not too long ago during the great recession:
  - SDRS' FVFR dropped to 76%, triggering Board recommended corrective action legislation
  - The legislation was challenged but upheld in Circuit Court
- Combination of subsequent market recovery and corrective actions returned the FVFR to 100% by 2012

Sustainability and Recent Changes

- The Board's primary objective is to maintain a fully funded plan that is managed within the fixed statutory contributions
- Market volatility, demographic and workforce changes require a more flexible and equitable benefit design to maintain the well funded status of SDRS
- Changes were made to enhance sustainability and strengthen the support of, and confidence in, SDRS by members, employers and policymakers
- Two-step process:
  - Step 1: New design for new members adopted in 2016
  - Step 2: Additional changes for all members adopted in 2017

Step 1: Restructured Benefits for New (Generational) Members

- Applicable to members entering SDRS after June 30, 2017
- Defined benefit structure retained
- Cost of new structure equal to existing structure
- Subsidies/above average practices eliminated or substantially reduced
- Normal retirement age increased by 2 years
- Class A benefit multiplier increased to meet income replacement goals
- Variable Retirement Account funded with part of employer contributions, credited with portfolio earnings, and only payable at retirement, death or disability
- COLA limited to inflation with maximum and minimum

Step 2: Additional Changes for All SDRS Members

- Expand and refine the existing variable benefit features by adjusting COLA annually based on inflation and affordability
- Address unanticipated costs and compensation spiking issues:
  - Tighten definition of compensation
  - Extend Final Average Compensation to five-year period, with significant transition period
  - Expand compensation caps
  - Increased compliance monitoring and auditing

COLA Affordability Test Examples

- Example 1:
  - SDRS has FVFR of 100% or more based on Baseline COLA assumption of 2.25%
  - SDRS COLA payable is CPI-W rate with a maximum of 3.5% and a minimum of .5%
- Example 2:
  - SDRS has FVFR of 97% based on Baseline COLA assumption
  - Baseline COLA is not affordable
  - Restricted COLA assumption that results in 100% FVFR is 1.85%
  - SDRS COLA payable is CPI-W with a maximum of 1.85% and a minimum of .5%

Outcomes

- Enhanced sustainability
- Board objectives met
- A continuing well-funded, efficient, and effective defined benefit plan with expanded hybrid and variable features
- Restructured design for next generation of members
- An automatic, variable COLA based on inflation and affordability
- Unanticipated costs and compensation spiking issues addressed
- A SDRS FVFR of 100% or more under most circumstances
- Lessen the likelihood of additional changes required with a continuing commitment to additional changes when and if needed

Future Planning Issues

- Update SDRS policies and goals based on recent changes
- Appeal in process on disallowance of employer contributions to SDRS for reimbursement of federally funded employees
- Work to influence public policy based on SDRS success
- Refine risk measures and consider added disclosure of “what ifs”
- Establish plan for future benefit changes:
  - If required due to failure to meet funding goals
  - If permitted due to favorable experience that meets Board’s threshold
- Monitor, communicate, and recommend as advisable

Appendix

Comparison of Membership and Benefit Changes from 2016

Foundation Members and Benefits
(SDRS membership prior to July 1, 2017)

- Retirement Benefit Eligibility:
  - Normal Retirement Age: 65/55 (Class A and Judicial / PS)
  - Early Retirement Age: 55/45, 3% per year reduction
  - Special Early Retirement (Rule of 85/75/80)
  - Three-year vesting
- Benefit Formulas and Features:
  - 1.55% for Class A
  - 2% and 3.3%/2% for Class B PS/Judicial
  - Class A Alternate Formula
  - Level Income
  - Final Average Compensation – Three years
  - No Variable Retirement Account (VRA)
- PRO: Refund of member contributions plus 85% of employer contributions (50% if not vested)
- Survivor and Disability Benefits:
  - Pre-Retirement Survivor
  - Post-Retirement Survivor – 60% of member benefit
  - Disability Benefits
  - No Variable Retirement Account
- Other Features:
  - Service Purchases – Age based and actuarially determined
  - Redeposits – First two years after reemployment
  - Return to Work
    - After Early Retirement – Suspended
    - After Special Early Retirement – Reduced and no COLA
    - After Normal Retirement – Reduced and no COLA

Generational Members and Benefits
(SDRS membership begins on or after July 1, 2017)

- Retirement Benefit Eligibility:
  - Normal Retirement Age: 67/57 (Class A and Judicial / PS)
  - Early Retirement Age: 57/47, 5% per year reduction
  - No Special Early Retirement
  - Three-year vesting – **No change**
- Benefit Formulas and Features:
  - 1.80% for Class A
  - 2% and 3.3%/2% for Class B – **No change**
  - No Class A Alternate Formula
  - No Level Income
  - Final Average Compensation – Five years
  - VRA to supplement Base Benefits at retirement
- PRO: Refund of member contributions plus 85% of employer contributions (50% if not vested) – **No change**
- Survivor and Disability Benefits:
  - Pre-Retirement Survivor – **No change**
  - Post-Retirement Survivor – Member Costs
  - Disability Benefits – **No change**
  - VRA to supplement Survivor and Disability Benefits
- Other Features:
  - Service Purchases – **No change (but separate tables)**
  - Redeposits – Eliminated – No redeposits
  - Return to Work
    - After Early Retirement – **No change**
    - After Special Early Retirement – Not applicable
    - After Normal Retirement – **No change**

Additional Changes for All SDRS Members in 2017

Definition of Compensation

- Compensation is defined as wages paid to a member by the employer for credited service rendered during the period for which payment was earned.
- Any employer-funded benefit, allowance, or reimbursement is excluded.
- Payments in lieu of insurance, temporary pay not tied to additional duties, and payments that incentivize retirement are specifically excluded.
- Reporting compensation inconsistent with the definition is a Class 1 misdemeanor.

Additional Changes for All SDRS Members in 2017

Final Average Compensation (FAC)

- Phase-in longer averaging period for FAC starting July 1, 2021. As of July 1, 2022, five-year averaging period in place.
- Compensation for each year considered in FAC is limited to 105% of the highest compensation considered in any prior year in the final 10 years.
- Phase-in compensation caps starting July 1, 2020
- Compensation in the last quarter considered in FAC is limited to 105% of the highest compensation considered in any prior calendar quarter in the final 10 years.
- Employer and member contributions on compensation in excess of the cap paid to member at retirement with actual SDRS investment return.