TMRS Advisory Committee Meeting
June 21, 2012

Trends Across the Country

Changes in benefits at statewide public retirement systems are continuing. In the last 3 years all 50 states have reconsidered their benefit designs and some have done this annually. Certain states have raised member contributions so the current benefit structure could be sustained. Other states have increased age and service requirements for eligibility for full retirement. Another common modification has been to institute a second or lower tier of benefits for new hires or those who are not vested. In Texas, this type of modification was made at the Employees Retirement System and the Teachers Retirement System. Costs, philosophies about the appropriate retirement age, and comparisons to the benefits available in the private sector are driving these changes.

Cost of living adjustments (COLAs) are a major target in some states. COLAs have been reduced, restructured, or even eliminated as is the case in Oklahoma. Reductions in COLAs are popular among state legislatures because they result in an immediate cost savings to the plans.

Legislatures across the country are also considering the replacement of defined benefit plans with cash balance plans like TMRS and exploring hybrid approaches which reduce the defined benefits and add a defined contribution plan.

TMRS is in a good financial position relative to other plans and drastic fixes are not needed. It is a well-funded system.

Age/Years Retired Restrictions for COLAs

One approach to reducing costs of COLAs is to delay their inception for a given number of years or until the retiree reaches a certain age. For example, if a COLA is delayed until someone has been in retirement for 10 years, the cost savings are significant or about 3.27% of payroll for a selected TMRS city. On the other hand, a 3 year delay does not reduce costs very much. If a COLA is delayed until a retiree reaches age 62, assuming the average age at retirement in TMRS is the late 50's, the cost savings are about half of what they would be from delaying COLAs for 10 years or about 1.61% of payroll. Lowering the age or years after retirement will reduce savings even more.

Delaying COLAs could have a sizable impact on costs for public retirement systems where members are still able to retire at earlier ages. It should be noted that, unlike TMRS, many retirement systems with traditional defined benefit plans actuarially reduce early retirement benefits, resulting in lower benefits.

Flat Rate Ad Hoc & Repeating COLA Options, Non-Retroactive

Some cities have suggested the cost of repeating COLAs may not be sustainable in the long-term. As a result, some cities view an ad-hoc flat rate COLA, not tied to the Consumer Price

Index (CPI) without the catch-up or retroactive feature to be a way to provide an occasional ad-hoc COLA at a lower cost than the current ad-hoc COLAs. A sample calculation of the cost of an ad-hoc COLA, without the catch-up feature, was $1 million less per year than the current ad-hoc COLA. A flat rate ad-hoc COLA, without the catch-up feature, may not keep pace with inflation. Ad-hoc COLAs must be adopted by council action every year.

Currently most TMRS cities have repeating COLAs. If a city has adopted an annually repeating COLA and then turns it off, the city must comply with a catch up or retroactive feature that increases the cost of turning the repeating COLA back on. A sample calculation of the cost of a repeating COLA without the catch up feature is about $1 million less per year than the current repeating COLA. Both methods result in contribution rates in excess of 20%, i.e., 20.81% vs. 21.48%. 37 TMRS cities have turned off their repeating COLAs since 2007. Between 20 and 30 cities have reduced the COLA percentage they provide since 2007.

New Governmental Accounting Standards Board (GASB) Statement No. 68 will change (effective in 2014) the reporting requirements of pension benefits in the employer's financial statements. While the new accounting rules do not directly alter the level of pension benefits provided nor the contributions made from a funding perspective, they could influence behavior regarding plan benefit and funding levels. The changes, when implemented, may result in large liabilities being reported in employers' financial statements. Such disclosures may cause employers to consider reducing retirement benefits such as COLAs to reduce the liabilities reported on their financial statements.

Variable, Non-Retroactive Repeating COLA Option

One new approach to COLAs for TMRS could be a variable COLA that would not require a retroactive catch-up. Such a COLA could only be adopted on a repeating basis. For example, a city could target a 50% of CPI COLA level for funding purposes, but could grant a 70% of CPI COLA in a given year which would increase the Unfunded Actuarial Accrued Liability (UAAL) or the city could grant a 30% of CPI COLA which would decrease the UAAL. Under this approach, cities must choose and commit to a certain default level (30%, 50%, 70%, etc.) for funding purposes, but they would have the flexibility each year to grant a COLA that is different than the default level. This approach, however, does not assist cities that find themselves unable to offer a repeating COLA at any percentage of CPI.

This approach marries a repeating COLA with an ad-hoc COLA. This is essentially a repeating COLA that is funded and provides a COLA at the selected default rate, but allows the city to change the COLA percentage to a different rate on an ad-hoc basis. This approach provides sounder funding than merely adopting annual ad-hoc COLA increases since some degree of advanced funding is taking place. The absence of the retroactive feature addresses some of the cost issues inherent in adopting a repeating COLA. As noted in the previous presentation, adopting a repeating COLA, even at the lowest % of CPI, can be expensive.

This variable COLA option could be offered as a new ongoing optional feature of the plan or only during a window of time. A variety of windows could be made available but windows can result in administrative and legal difficulties, sometimes including litigation. A window could be structured as a one time open ended opportunity that eliminates time limits for opting into this COLA but still penalizes the cities if they ever turn off the repeating feature, by requiring the city to use the retroactive feature for future COLA adoptions. It is important that the windows and the restrictions not be too complicated.

When considering which cities should have certain COLA opportunities, those without Social Security have greater needs than those with Social Security and the COLA it provides.

Legislative Update

Before any statutory changes are proposed to the TMRS Board and any legislation is drafted, it is important to understand the current political landscape, be informed about recent and upcoming changes in Texas, and understand where the Legislature is at this point. Since the last Advisory Committee meeting, the Wisconsin Governor, Scott Walker, who initiated changes to collective bargaining and pensions in Wisconsin was recalled and then re-elected. In addition, the PEW Center reported that public retirement systems in 34 states were below the 80% funded level. And, the citizens in two California cities, San Diego and San Jose, elected to reduce pension benefits to public employees due to the increasingly high costs of their plans.

All of the retirement systems in Texas are on the Legislature's "radar screen." This is likely to be the most challenging session the systems have ever encountered partly due to the experience level of legislators. Possibly as many as 79 legislators will have one session of experience or less. We expect to see legislation filed to change the structure of the statewide systems.

Texas House

In Texas, the House has 150 members (currently 101 Republicans and 49 Democrats) and is run by the Speaker who is elected from the members of the House. The House currently has 36 committees.

Due to the incumbent retirements and the results of the primary election on May 29th, the House is expected to have fewer Republicans, but overall it will be more conservative. Looking forward, there could be up to 41 new legislators in the House next session. The House Pension Committee will be considerably different because 4 of 9 Committee members, including the current committee chair, will not be returning. It will be late January or early February before committee assignments are made and we will know the Committee Chair and members of the Pensions Committee. The House sponsors of the last two TMRS bills are no longer going to be in the Legislature. It will be a challenge to educate someone new on TMRS issues.

Texas Senate

The Senate has 31 members (currently 19 Republicans and 12 Democrats) and is presided over by the Lt. Governor who is a statewide elected official. The Senate currently has 20 committees.

Four senators chose not to run for re-election and 4 House Republicans are running for Senate seats. The possible changes could be dramatic with 4 to 6 new Senators. Six new senators would be unprecedented in the Texas Senate, which typically has little turnover. The Senate potentially may have one more seat turn Republican. Finally, pending the November elections, the Lt. Governor may change as well.

Strategy

Legislation that has the highest chance of being passed is that which makes the fund stronger (better performance, more efficient, etc.), benefits all TMRS cities, and has united support from the stakeholders. Even with unanimous support from the Advisory Committee, it will not be easy to get legislation passed. Legislation that is merely a “wish list” will be difficult to pass.

On the positive side, TMRS does not receive state funding. On the negative side, TMRS is the only statewide plan that has any sort of ongoing COLA, so any bill that changes COLAs will probably get some attention.

ERS and TRS are currently conducting legislatively-mandated studies about transitioning their plans from defined benefit plans to defined contribution plans, cash balance plans, or other types of hybrid plans. The studies are due September 1, 2012.

City Survey Results

The TMRS staff surveyed cities about COLAs at the request of the Advisory Committee. COLAs are valued as a recruitment and retention tool. Not surprisingly, 20 out of 20 said cost was the main factor in eliminating or reducing their COLAs. No city stated that it planned to re-adopt an annually repeating COLA without legislative changes. Of those 20 cities, five said they were considering adopting ad hoc COLAs next year but other cities didn’t think they would be able to provide any COLA. COLA proposals of most interest to the surveyed cities was removing the retroactive feature and a flat rate COLA.

Gainsharing

In past Advisory Committee meetings there was some interest in learning about gainsharing, a plan design by which members and the cities share in higher than expected investment returns. Investment returns for purposes of gainsharing should not be viewed on a year by year basis. They trend over decades or multiple decades.

Discussions about gainsharing are more prevalent in defined benefit plans than in cash balance plans because in cash balance plans the liabilities and assets are tied together. TMRS could design some sort of gainsharing feature but legislation would have to authorize it and it would have to be implemented at the local level and only with care and discipline and in conformance with strict guidelines and safeguards for those times when investment returns are low. TMRS would have to outperform its assumed return by a significant amount over a long period before it would be prudent for anyone to consider gainsharing.

The downside to gainsharing is that it is not equitable across generations and it could put future benefits at risk if not designed and implemented correctly. .

The presentation provided a basis for future discussions, but the Committee did not indicate a desire to pursue gain-sharing this session.

Next Steps/Future Meetings

The next meeting, expected to be two to four hours in length, was set for August 16, the day before the next Board meeting. Prior to that meeting the Advisory Committee will be given a list of benefit options to consider so that final recommendations to the Board can be discussed at the August meeting. It was noted that COLA options for cities without Social Security coverage may be different than options for those with coverage. The Advisory Committee will also review and discuss a written statement of philosophy intended to give general guidance about where the Advisory Committee would stand on other legislation.

TMRS staff will solicit input before the meeting. This will encourage advance thinking on the options and philosophy.

PARTICIPANTS		
TMRS Board Members		**Advisory Committee Members**
Frank Simpson		Allen Bogard (via Conference Call)
Julie Oakley		Don Byrne
		Ron Cox
TMRS Staff		David Crow
David Gavia		Dean Frigo
Eric Davis		Flor Garcia
Christine Sweeney		Jerry Gonzalez
Dan Wattles		Scott Kerr
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