Summary:
TMRS Advisory Committee Meeting
March 29, 2012

National Overview of COLA Trends

Status of Public Plans Now

TMRS is in an enviable funded position compared to many other public plans. TMRS has a projected funded ratio of approximately 85% (as of 12/31/2011) which is not common among public funds.

Strong bond holdings shielded TMRS from the sharp investment declines and falling funded ratios experienced by many other funds across the country. Other factors that contributed to TMRS' success: Senate Bill 350 and receipt of the ARC (annual required contribution).

Long Term Rates of Return

Numerous public plans across the country are lowering their long-term investment return assumption believing that an 8% investment return, that was common, is not attainable over the long term, primarily due to lower expected long-term inflation rates.

Assumption reductions may have a ripple effect causing other public plans to question whether their assumption should be reduced, particularly since many assume inflation at 3.5%.

Increasing contribution rates will put increased fiscal pressures on plan sponsors. At least one large state-wide plan thinks the reductions in interest rate assumptions are an overreaction to an anomaly in the capital markets.

TMRS' long-term investment return assumption is 7%, which the actuary believes is reasonable given TMRS' current and proposed asset allocation. Other Texas plans have not reduced their assumed rate – TRS, ERS and TCDRS are all still at 8%.

Life Expectancy – Historical Trends

Life expectancy continues to increase, especially for females. The conservatism that was built into the assumption has diminished greatly due to improvement in life expectancy.

Improved life expectancy means people will generally receive benefits for a longer period of time and therefore the benefits will generally be more expensive.

Declining Funded Ratios

Looking back to when public plans were first established, it is clear that funded ratios of public plans have historically been below 100%. Over the last twenty years, funded ratios of public sector plans have been at least 80% for the most part.

Contributions Experience

More than investment returns, the lower funded status of many plans is a direct result of employers not paying the ARC to the systems.

Cities that are part of a statewide retirement system have been better at paying the ARC than state governments (e.g., Illinois, Oklahoma,); however, city governments where there are stand alone city plans, like in Chicago and Los Angeles, have also been less disciplined at paying the ARC, so those cities also have a lower funded status. Competing interests at the state level may make it more difficult for decision-makers to be disciplined about paying the ARC.

How did Public Plans Get Here?

The current funded status of many plans is due primarily to the financial market decline of 2008,in which many public funds lost up to 1/3 of their assets. Other external factors were: rising unemployment, economic decline, falling housing values, and falling state and local revenues. Some of the internal factors were: the late 1990's benefit increases, investment risks, and plan sponsors not contributing the ARC.

Where are Public Plans Going?

Benefit decreases are being enacted, usually for new hires, typically starting with COLAs. COLAs are a target because they are an expensive benefit and because they may not have the same legal protections as the benefit formula under the applicable state laws.

Postemployment COLA's have recently been revised in ten states. In all ten, future COLA's were reduced. In three of the ten, the COLA change affected current recipients; this has resulted in litigation.

- Oklahoma did away with automatic COLA's. The funding source for a COLA now must be specifically identified before it can be enacted.

- In Wyoming, the Plan has to be 120% funded in order to grant a COLA.

- Arizona has implemented a two-prong risk sharing approach for granting COLAs: (1) investment earning must be at a specific level, in excess of 10.5%, and (2) the funded ratio must be at least 60%. Assuming the investment earnings requirement is met, then the amount of COLA grows incrementally from 2% (if the plan is at least 60% funded) to 4% (if the funded ratio is at least 80%). If the earnings above 10.5% are not sufficient to fully fund the intended COLA, the COLA increase is limited to the amount that can be funded with the excess earnings. Any excess is not carried over to future years. .

- Rhode Island has also tied the granting of COLA's to a funded ratio of at least 80%, but allows for intermittent COLAs before the 80% target is reached. The COLA is equal to the difference between the five-year smoothed investment return and 5.5%, but not less than zero and not greater than 4%. In Rhode Island, the COLA applies only to the first $25,000 of a member's benefit. The limit is indexed to inflation.

- Connecticut reduced their automatic COLA from 2.5% to 2.0%.

- Hawaii reduced their automatic COLA from 2.5% to 1.5%

Some states are pushing out the time before a retiree first becomes eligible for a COLA as a way of saving money.

The Impact of Proposed GASB Disclosures on COLAs

GASB released its Exposure Draft (ED) in 2011. The ED proposes changing the standards applicable to public pension accounting and reporting.

Pursuant to the new standards, (1) accounting and funding would be decoupled, and (2) the unfunded pension liability ("net pension liability") would be included on the employer's (plan sponsors) financial statement.

Potential implications of the new standards include:

- creation of separate accounting and funding measures may cause confusion regarding the "real costs" and funded status of a public pension plan – one number is for accounting and another is for funding,
- the "net pension liability" may be more volatile than the liability that is currently being disclosed (the unfunded actuarial accrued liability),
- the amount that will be reported on the employer's financial statement will likely increase from what is currently being reported in the notes to the statement,
- the accounting concept of an ARC will go away in GASB reporting, and
- ad hoc COLAs will have to be valued to the extent that they are considered to be "substantively automatic" – this standard will be very difficult to interpret and left to the judgment of the actuary.

The new GASB standards will not technically change what cities have to fund. But, because the standards will change how the balance sheets of cities will look, they could drive behavior and change funding implicitly. COLAs are likely to be the first target because they are expensive and modifying them will have the greatest immediate cost-saving impact.

Current TMRS COLAs and Employer Flexibility

Current TMRS COLA options are 30%, 50%, or 70% of CPI-U.

Ad-hoc vs. Repeating COLAs

The repeating COLAs are advanced funded over the active employee's working career.

Repeating COLA rates are stable. Although costs for repeating COLAs are higher in the short run, the unfunded actuarial accrued liability (UAAL) decreases over time and the funded ratio improves.

Ad-hoc COLAs are funded when granted over 15 years using level dollar amortization.

In the short term, ad hoc COLA rates are lower, but the “stacking effect” results in greater costs with each Ad-hoc adoption. Unlike repeating COLAs, the UAAL for ad-hoc COLAs increases over time and the funded ratio declines.

In the long run, cumulative contributions for ad-hoc COLAs exceed those for repeating COLAs. The difference in the long term costs of ad hoc versus repeating COLAs is attributable to the investment earnings accumulated from advanced funding the repeating COLAs.

Nationally, the trend is toward not making COLAs automatic, but currently within TMRS 96% of the COLAs adopted are annually repeating (“automatic”).

Bottom-line: Consistent adoptions of ad hoc COLAs is less cost effective in the long-term when compared to repeating COLAs because, interest earnings accumulated through advance funding are not available to offset costs under the ad hoc approach.

Retroactive Nature of Current COLAs

One of the unique features at TMRS, and one of the reasons they are so expensive, is that COLAs are retroactive – the COLA calculation measures the change in the CPI-U from the December before retirement through the December that is 13 months prior to the effective date of the COLA. This “catch-up” feature can add cost if a COLA has not been granted for some time, or especially with the initial COLA adoption.

Adoption of an increase in the percent of CPI-U selected by a city (i.e. 30%, 50% or 70%),, or initial COLA, results in large benefit increases for the year adopted; those retired longer will receive higher increases.

Adoption of a reduction in the CPI-U selected results in lower or no increase until the cumulative increase at the lower percent exceeds the current benefit; those retired longer will have longer to wait to receive another COLA increase.

If the goal is to maintain the retirees’ purchasing power, then the TMRS approach accomplishes this.

<u>COLAs Based Upon Investment Earnings</u>

If assets don’t keep up with liabilities, contributions have to increase to fund benefits. COLAs based on investment earnings are one way to spread funding risk between the employer and the retirees.

COLAs based upon investment earnings dampen the growth of plan liabilities when investment returns are low.

Using this approach, the granting of a COLA is contingent upon investment earnings meeting a predetermined threshold. As a result, COLAs are not guaranteed.

Arizona and Rhode Island are examples of two states that tie the granting of COLAs to investment earnings.

COLAs Based on a Bank of Reserves

An “account” is established “on paper.” The account is equal to the value of the monthly pension benefits – the liabilities of the retirees.

This approach uses no projected liability or amortization.

If investment returns produce a surplus in the account, pension benefits may be increased and a “dividend” can be paid. The term “dividend” is used rather than COLA, but in effect they are the same.

Like the “investment earning” contingent approach, this method also helps to allocate plan funding risks between employers and retirees, and dampens the growth of plan liabilities when returns are low. It provides an additional benefit when returns are high.

The Wisconsin Retirement System (WRS) is a public pension fund that has adopted this approach. WRS established the Retired Life Reserve Account (the Account). In order for a dividend to be granted, the Account must generate returns greater than 5%. Investment earnings are smoothed over a 5 year period.

Dividends are not guaranteed and they may actually be reduced if the Account falls below the value of the pension liabilities.

The 2008 market decline resulted in a negative dividend in the Account because the assets fell below the liabilities. A “negative dividend” or a “clawback” of -2.1% was applied to all annuities, resulting in a reduced payment. The dividends have been negative over the past 4 years. Although negative dividends can be applied, the WRS approach is designed to prevent an individual’s current pension benefit from being reduced to an amount less than the person’s original pension benefit.

Allowing an Employee to Self Fund a Fixed Rate COLA Through a Reduction in Initial Retirement Benefits

This approach allows a retiring employee to “self fund” a fixed rate COLA as an optional annuity form of payment. . It can be beneficial for employees that may not have adequately planned for or have no other resources to protect against future loss of purchasing power.

A retiring member may elect a lower initial monthly benefit with the promise of a guaranteed annual COLA increase at a fixed rate, rather than tied to the CPI-U.

A member may elect to work longer to obtain the desired monthly benefit and “self fund” their guaranteed COLA.

It can be determined how long the member will have to live for the reduced benefit to overtake the original benefit amount.

This approach is another form of retirement planning and can be used in conjunction with benefits funded by the employer.

There are complexities of administration if benefits are employer and employee funded.

COLAs are very important particularly if retirees don't have Social Security. Purchasing power is negatively impacted in the absence of a COLA.

Agenda Items for the Next Advisory Committee Meeting

The next meeting of the Advisory Committee will be May 3rd from 9 to 3.
Agenda items will include:

- Fixed or Flat Rate COLAs
- Windows for Employer Choices
- COLAs Funded by Additional Employee Contributions
- COLAs Triggered by Funded Status
- COLA Summary
- Plan Design Features – Delayed Retirement Eligibility
- Additional Employee Contributions to Maintain or Increase Benefits
- Supplemental Plans Discussion (Plano and Irving Retirement Plans and their use)

Information Requested from Members

The funding ratios and investment and inflation assumptions for the larger funds to differentiate TMRS from other funds. For the largest funds in Texas, see the Pension Review Board's, "Guide to Public Retirement Systems in Texas, January 2011." (http://www.prb.state.tx.us/files/reports/2011primer.pdf)

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