TMRS Advisory Committee Meeting
May 3, 2012

State Legislative Pension Changes

From 2009 through 2011, 43 states enacted major changes in state retirement plans for broad categories of public employees and teachers to address long-term funding issues. Several states acted more than once during the period. The changes were designed to reduce pension fund obligations by increasing employee contributions or age and service requirements for retirement, or both, and adjusting benefit provisions in various other ways that reduce costs**.**

TMRS Cost of Living Adjustments (COLAs)

Currently, the TMRS COLA options are 30%, 50%, or 70% of the consumer price index for all urban consumers (CPI-U). Repeating COLAs are now advance funded over each active employee's working career. An increase in the CPI-U results in a COLA benefit increase. TMRS COLAs can be granted either on an annually repeating basis or ad hoc. Ad-hoc COLAs are now funded when granted over 15 years with level dollar amortization.

The retroactive or "catch up" COLA feature is a distinctive feature of TMRS, as is Updated Service Credit.

Flat-Rate COLAs: Pros and Cons

A flat-rate design could enhance the employer's ability to control the cost of COLAs. Like the current COLAs, a flat-rate COLA could be either repeating or ad-hoc. When investment returns are low, a flat-rate COLA can be used to reduce plan liability growth. However, flat-rate COLAs that are not tied to the CPI may not keep pace with inflation. Also, if there has been a period of no COLAs, then a flat-rate COLA does not restore lost purchasing power evenly across retirees. CPI-based COLAs, if affordable and sustainable, are the best choice for maintaining some or all of a retiree's purchasing power.

In the example provided the contribution rate for a 70% CPI ad hoc increase for a city that has not granted an ad hoc increase since 2008 is 12.62%. The contribution rate for that same city for a 70% CPI ad hoc increase without the catch up is 11.85% or a difference of about $1,019,087 in contributions per year for the 15 year amortization period. The longer it has been since the last ad hoc adoption, the more expensive the catch up provision causes COLA increases to be. There is a concern by some committee members that these types of ad hoc COLA options without a catch up will cause more cities to drop repeating COLAs and adopt ad hoc COLAs on an irregular basis, leaving retirees without a predictable COLA.

Texas County District Retirement System (TCDRS) COLAs

The TCDRS offers two COLA options: (1) CPI-U based and (2) flat- or fixed-rate. The TCDRS COLA design provides only for ad-hoc adoptions. TCDRS does not offer a repeating COLA option. The cost of TDCRS' COLAs is amortized over a closed 15-year period. The CPI-based option is retroactive and calculated just like TMRS' COLAs. TCDRS has more percentage-of-CPI options than TMRS – they offer from 10% to 100% in 10% increments on the CPI-based option.

Flat-rate or fixed-rate COLAs were first implemented by TCDRS in January 2000. The option was intended as an affordable alternative to CPI-based COLAs for employers that had never adopted a COLA. TCDRS originally allowed COLA percentage increases equal to any integer without a cap. In January 2007, a cap was implemented on allowable integer COLA increases. Because some county employers adopted COLAs in excess of inflation over many successive years, the TCDRS Board believed the spirit of flat-rate COLAs was not being followed. Since 2007, the maximum annual flat-rate COLA has ranged from 0% to 4%. The applicable TCDRS law requires that a maximum be set annually, but the law does not prescribe the methodology, which allows some flexibility. Current TCDRS Board policy provides for setting the maximum based on the previous year's change in the CPI-U, rounded to the nearest integer.

In 2009, because of the flat-rate caps, TCDRS added 10% and 20% of CPI into their COLA options as another, more affordable choice. Flat-rate COLAs were not available for 2010 because of very low inflation. In 2009, 1%-4% COLA increases were available.

The percentage of TCDRS plans adopting COLAs between 2008 through 2012 was 28%, 27%, 9%, 13%, and 9%, respectively.

Information Request: The Advisory Committee requested TMRS historical data over the last 5 years regarding the percentage of employers adopting 30%, 50%, and 70% options granted year to year.

Windows for Employer Choices

The "window of opportunity" concept would allow TMRS employers to add a repeating COLA without the current retroactive or "catch-up" requirement during a limited period of time or "window". However, the option may be complex to administer as a stand-alone provision; the administrative costs could be more expensive than a permanent option.

An example, using a city that last adopted a 70% COLA in January 2008, demonstrated that the baseline (no COLA) estimated contribution of $15, 246,601 almost doubled with a 70% repeating COLA with "catch-up," to $28,428,559. The 70% CPI repeating COLA estimated contribution with no "catch-up" is $27,541,821. In the example, the additional annual cost to provide the 70% CPI repeating COLA with "catch-up" is $13,181,958 versus $12,295,220 without "catch-up." The contribution rate for the repeating COLA with a catch-up is 21.48% and 20.81% without a catch-up. The longer it has been since the last COLA, the greater the difference between the two methods.

Discussion Regarding COLAs

Legislation filed in 2011 by Senator Kel Seliger would have provided a flat rate TMRS COLA without the "catch-up" feature. The City of Amarillo asked Senator Seliger to sponsor the legislation. The bill would have provided for a flat rate COLA on an ad-hoc or repeating basis. The Seliger bill passed the Senate but died in the House the last two sessions. The bill had the support of TML last session.

Some Advisory Committee members stated that the ad hoc COLA option in the Seliger bill was an effective tool to manage the costs of granting ad hoc COLAs over the current TMRS COLA options and allowed city staff to provide COLAs to retirees when funding was available. On the other hand, some committee members felt that repeating COLAs are extremely beneficial to retirees and help to preserve the purchasing power of retirees, especially retirees not covered by Social Security. Repeating COLAs provide predictability to retirees and may facilitate a city's ability to budget.

The vast majority of public employee retirees in Texas do not have a guaranteed COLA. The other three Texas statewide retirement systems do not have a guaranteed or repeating COLA. 90% of teachers in Texas are not covered by Social Security and no Texas teachers or state employees receive a guaranteed COLA.

In lieu of an approach like the Seliger bill that allows repeating or ad hoc COLAs without the current catch-up feature, a compromise was discussed that allows cities a one-time opportunity to adopt a repeating COLA without "catch-up." One alternative would be to allow an opt-in to a 30% repeating COLA with an option to move between a repeating, non-retroactive 50% and 70% of CPI-U COLA on an annual basis. If an employer that had adopted this option later turned off their repeating COLA, then the "catch up" requirement would apply permanently to subsequent COLA adoptions.

Additional Employee Contributions/Member Cost Sharing

Member cost sharing has been a common plan redesign component for many plans in the recent past. It allows employees to increase their contribution to keep their current benefit levels. However, a 1% increase in the TMRS member rate is not as effective as the same 1% increase in the employer rate. This is because there is a "leakage," or refund liability. Consequently, the additional employee contribution doesn't result in an equal decrease in the employer contribution rate.

There are also other challenges in a cash balance-type plan like TMRS. The member contribution balance has a direct impact on the retirement annuity. If a higher member contribution rate leads to higher retirement annuities, the "leakage" is even greater. A possible solution would be for the employer not to match the additional employee contribution, in which case a 1% employee contribution could lead to a 0.85% decrease in the employer rate.

COLAs Triggered by Funded Status

Some state legislatures, in an effort to restrict future COLAs, have tightened the parameters for Systems to give a COLA. In effect, the legislature takes the decision to grant a COLA away from the Board of Trustees. Examples of states that have imposed some form of COLA triggered by funded status include: Wyoming, Oklahoma, New Jersey, Rhode Island, and Arizona. This type of restriction spreads plan funding risk over employers and retirees and dampens the growth of plan liabilities when the plan's funded status is low or not improving. On the other hand, the likelihood that a COLA will be granted is diminished significantly. A COLA can only be granted if the triggers are met.

COLA Summary

The following COLA options have been discussed with the Advisory Committee to date:

- **COLAs Based on Investment Earnings** – Using this approach, the granting of a COLA is contingent upon investment earnings meeting a predetermined threshold.
  - No interest in this option was expressed by the Advisory Committee

- **COLAs Based on Reserve Account** – An “account” is established “on paper.” The account is equal to the value of the monthly pension benefits. 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.
  – No interest in this option was expressed by the Advisory Committee

- **A Self-Funded Annuity Option** – 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 who may not have adequately planned for or have no other resources to protect against future loss of purchasing power. TMRS does not have the ability to create this option at the Board level; a legislative change would be required. Wyoming is considering this option. . Nebraska’s cash balance plan does not have a regular COLA but has the “self-funded” COLA option. To date, it has not been heavily used by retirees. Using outside money (457 etc.) of a member to self fund a COLA could be an option.
  – Minor interest was expressed in this option; may be an option for consideration at a later date.

- **Non-retroactive 30%, 50%, and 70% CPI COLAs** – use an “open window concept” for cities that have either reduced or turned off repeating COLAs to reestablish them. For cities that have never participated in a COLA, the “open window” could be indefinite. A desirable window entry point may be a 30% repeating COLA with no “catch-up.” The percentage could change between 30%, 50%, and 70% to make it flexible. If a city opted out, i.e., turned off the repeating feature, after using the window, the “catch-up” would apply if they ever elected to opt in again.
  – The Advisory Committee has the greatest interest in obtaining more detail regarding this option.

- **Fixed- or Flat-Rate COLA** – allows non-CPI-based COLAs to retirees on ad hoc or repeating basis.
  -- The Advisory Committee had an interest in this option.

- **Additional Employee Contributions** – allows employees to increase their contribution to keep their current benefit levels. The option may be more desirable for cities without Social Security. This option can be very complicated.
  – The Advisory Committee expressed minimal interest in this option.

- **COLAs Triggered by Funded Status** – COLAs can only be granted when the funded status is over the predefined percentage levels attained.
  – The Advisory Committee did not appear to believe that this level of restriction on the granting of COLA was needed.

<u>Later Retirement Eligibility</u>

In 2011, 15 states increased their age and service requirements for normal retirement. The increases generally applied to people hired after the legislation’s effective date. The changes move retirement age closer to age 65 and often increase required service.

The savings to a cash balance plan like TMRS from using this feature are not as great. It has greater usefulness in a traditional defined benefit plan. In a traditional defined benefit plan, delayed retirement dates decrease the present value of the benefit due to the shorter payout period. In a cash balance plan, the present value at retirement is the account balance from which the annuity amount is determined.

Consequently, in a cash balance plan, both the account balance and resulting annuity amount increase with delayed retirement dates. In the example presented, a city that moved from a retirement eligibility of 20 years of service at any age to a retirement eligibility of 25 years of service at age 55, would see a reduction in its contribution rate from 18.75% to 18.04% or a savings of about .71%.

Later COLA Eligibility

Placing an age and/or length of retirement requirement on the payment of a COLA is an option. For example, some jurisdictions require that recipients must be at least age 62 before receiving a COLA or must be retired for 10 years before receiving it.

The Advisory Committee expressed a desire to obtain additional information on age and length of retirement as a COLA prerequisite.

Supplemental Plans

The cities of Plano and Irving are both not in Social Security and have each established a supplemental plan to make up for the lack of Social Security. A supplemental plan also allows for a more robust disability benefit. The disability benefit is the biggest component of these plans.

Plano's supplemental plan does have a CPI-based COLA, which is payable during the retiree's life only. Disability ceases at 65 and then retirement will kick in.

A supplemental plan makes up for the lack of a Social Security benefit. It provides short service members with a meaningful disability benefit. A plan like this would have to be created outside of TMRS. It increases retirement costs for the plan sponsor and there may be legal issues associated with establishing this type of plan.

The Alternate Plan

Three Texas TCDRS counties participate in the Alternate Plan – Galveston, Matagorda, and Brazoria. It is a defined contribution approach created 30 years ago as an alternative to Social Security. Like Social Security, employees contribute 6.2% with a county match of the same 6.2%.

Agenda Items for the Next Advisory Committee Meeting

The next meeting of the Advisory Committee will be June 21st from 9 to 3.

Agenda items will include:

- Gainsharing
- Additional detail on the following options:
  - Flat-rate COLAs – ad hoc and repeating
  - Non-retroactive repeating COLAs
  - A one-time opt-in window with a 30% repeating COLA with flexibility for 50% and 70%
  - Age and service limits before a COLA can be received
- Survey results of the cities that turned off repeating COLAs to determine why the COLAs were turned off, and under what circumstances the city might consider readopting a COLA in the future.

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