2017 Proposed Legislation

South Dakota Retirement System

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SDRS Mission Statement

To plan, implement, manage, and efficiently administer financially sustainable retirement income programs within the fixed resources available.

SDRS Core Values

Provide members and their families the opportunity to achieve financial security at retirement, death, or disability by delivering appropriate and equitable benefits, and promote, encourage, and facilitate additional member savings for retirement.

SDRS Long-term Income Replacement Goals

Provide lifetime income replacement of at least 55 percent of final average compensation for career employees in each membership class.

Promote total lifetime income replacement of at least 85 percent of final average compensation, including income from SDRS, Social Security, and personal retirement savings of at least one time annual compensation at retirement.

Fiscal and Actuarial Information Concerning SDRS Legislative Proposals

The Board of Trustees approved changes in the actuarial assumptions on November 3, 2016, which will increase the SDRS accrued liability by $1.205 billion and the determination of the unfunded liability will change from the actuarial value to the fair value of assets, which recognizes an additional $338 million of liability, for a total unfunded liability of $1.543 billion. House Bill 1016 will reduce the SDRS accrued liability by approximately $443 million due to a reduction in the expected long-term average SDRS COLA. In addition, House Bill 1016 will reduce the SDRS liabilities when the maximum COLA is required to be reduced. This will vary from year to year depending on the funded status of the System. For example, had the process detailed in the bill been in place for 2016 with the newly adopted economic assumptions, the accrued liabilities of SDRS would have been reduced by an additional $1.100 billion and the maximum COLA payable July 1, 2017 would have been 1.25%.

Furthermore, if House Bill 1018 is also enacted, the SDRS accrued liability will be reduced by $105 million. Had the provisions of both bills been in place for 2016, the additional reduction in accrued liabilities would have been $995 million and the maximum COLA payable July 1, 2017, would have been 1.35%.

HB 1016

An Act to revise the methodology for calculating the cost of living adjustment for South Dakota Retirement System benefits, to revise reporting conditions, and to provide uniform terminology.

The Issues

The Board of Trustees adopted changes in the actuarial assumptions, effective with the June 30, 2017 actuarial valuation. Based on these assumptions, SDRS will not meet the board's funding policy or the requirements of SDCL 3-12-122 without corrective actions.

The SDRS cost of living adjustment (COLA) is very expensive and provides a benefit in excess of both inflation and the board's goals.

The Solution

Revise the COLA to vary directly and automatically with inflation, experience, and affordability.

Legislative Summary

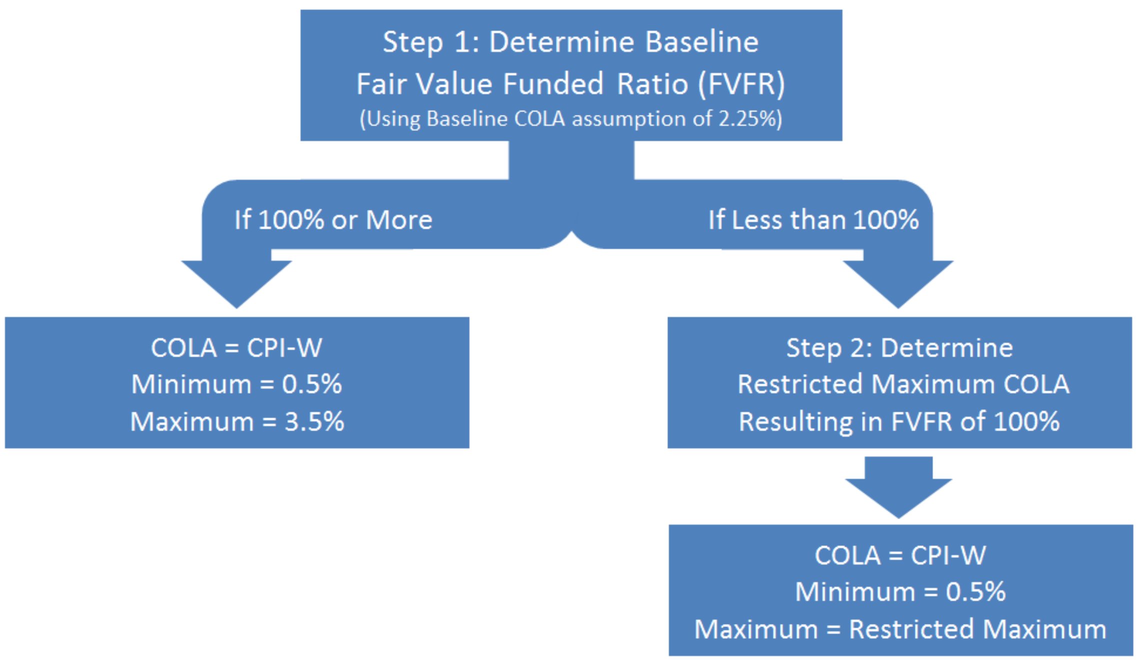
- **If SDRS is fully funded (fair value funded ratio (FVFR) is 100% or greater), the COLA payable is equal to the change in CPI-W, with a minimum of 0.5% and a maximum of 3.5%.**
- **If SDRS is not fully funded, a restricted COLA maximum is calculated that results in SDRS being fully funded, and the COLA payable is equal to the change in CPI-W, with a minimum of 0.5% and a restricted COLA maximum.**
- **Reporting requirements are revised to include recommendations to the Governor and Legislature if the FVFR is less than 100% based on the restricted COLA maximum or if the actuarially required contributions are greater than the statutory, fixed contributions.**
- **Terminology is revised in a number of statutes and rules.**

The Background

The board adopted changes to the actuarial assumptions—price inflation from 3.25% to 2.25%; investment return from 7.25% to 6.5%; and wage growth from 3.75% to 3%. Based on the revised assumptions, SDRS funding measurements do not meet the SDCL 3-12-122 thresholds or the board's funding objectives and the fixed, statutory contributions do not support the current benefit structure. To bring SDRS back to actuarial balance, changes are proposed to the COLA design as well as the definition of compensation, computation of final average compensation, and compensation caps.

This flexible COLA design will match the SDRS liabilities with the available resources and maintain a FVFR of 100% in most economic environments. In the event of a severe market correction or an extended period of experience worse than assumptions, SDCL 3-12-122 will require consideration of additional changes.

Proposed COLA Process



The Actuarial Statement: House Bill 1016 will reduce the SDRS accrued liability by approximately $443 million due to a reduction in the expected long-term average SDRS COLA. In addition, House Bill 1016 will reduce the SDRS liabilities when the maximum COLA is required to be reduced. This will vary from year to year depending on the funded status of the System. For example, had the process detailed in the bill been in place for 2016 with the newly adopted economic assumptions, the accrued liabilities of SDRS would have been reduced by an additional $1.100 billion and the maximum COLA payable July 1, 2017, would have been 1.25%.

HB 1017

An Act to revise the definition of compensation for the purposes of the South Dakota Retirement System, to provide a penalty for falsely reporting compensation, and to update references to the Internal Revenue Code.

The Issue

The SDRS retirement benefit is based on a member's final average compensation, years of service, and a multiplier. Clearly defining the term, compensation, is imperative to limit compensation as intended. This will result in a retirement benefit based on a member's typical compensation, not artificially inflated compensation.

The Solution

Clarify and tighten the language relating to the inclusions and exclusions to the SDRS definition of compensation and provide a penalty for falsely reporting compensation to SDRS.

Legislative Summary

- **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.**
- **Same compensation limit applicable to members hired after July 1, 1996, applied to members hired before that date.**
- **References to the Internal Revenue Code are updated.**

The Background

The compensation of some retiring members has been increased due to the improper inclusion of certain payments. Clarifying the definition of compensation and adding a penalty for wrongfully reporting otherwise non-includable compensation will address this inequity.

Contributions to SDRS are currently made on compensation above the Internal Revenue Code limits for a very few members hired before July 1, 1996, since the limit only applies to members hired after that date. This proposal would result in a uniform application of the limit for all members effective January 1, 2018.

References to the Internal Revenue Code are also updated to remain in compliance with IRS requirements.

Compensation Defined for SDRS

Inclusions	Exclusions
Wages, tips and other W-2 compensation	Payment, reimbursement or allowance for expenses (travel, meals, lodging, moving, uniforms, others)
Member contributions made by employer after 6/30/84	Lump sum payment for sick leave
Member contributions to:	Lump sum payment for annual leave
IRC Section 125 plan	Payment for/in lieu of insurance coverage
IRC Section 401 plan	Temporary payments not due to additional duties*
IRC Section 403 plan	Allowances or payments for housing or vehicles*
IRC Section 408 plan	Payments based on/attributable to retirement
IRC Section 457 plan	Payments that result in an incentive to retire*
Prior service purchase/ IRC Section 414(h)(2)	Payments upon dismissal/severance/termination
	Worker's compensation payments

* New exclusion in proposed legislation. Other changes highlighted.

The Actuarial Statement: House Bill 1017 will eliminate approximately $4 million in unanticipated annual costs. It will have no impact on the current liabilities of the System and will enhance equity among all SDRS members.

HB 1018

An Act to the revise the computation of final average compensation for benefits relating to the South Dakota Retirement System.

The Issue

Large, late-career increases in compensation result in significantly higher benefits and liabilities than career contributions plus investment income have funded. Large, late-career increases in compensation have always created inequities; however, with the proposed new COLA structure, these increases will directly impact the maximum COLA payable to all current and future retirees. The current computation of final average compensation (FAC) uses three years, which is very short and contributes to the problem.

The Solution

Change from three-year to five-year FAC with a significant transition period. The member's FAC computed as of June 30, 2017, would be a minimum FAC during the transition period.

Also expand current compensation caps to five percent per year for the entire FAC period, with a similar significant transition period and pay member and employer contributions on compensation in excess of the cap to the member at retirement.

Legislative Summary

- **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.**
- **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.**
- **No change to generational member FAC; currently at five-years. Generational member caps have no phase-in as first members will join July 1, 2017.**

The Background

Large, late-career compensation increases may be due to a number of causes but are exacerbated by deliberate attempts to inflate SDRS benefits. They result in a subsidy to some members at the expense of others and a significant unanticipated cost to SDRS. SDRS' ability to police employer and member actions is difficult with more than 480 employers and compensation policies that vary greatly and change frequently.

Several recent retirees had large compensation increases in the second and third year prior to retirement—years that are not currently subject to the cap. In addition, one quarter of high compensation prior to the last four quarters generally makes the current cap ineffective.

With the actuarial assumption changes, the annual cost of accruing benefits will be nearly identical to the fixed, statutory contributions with little margin for adverse experience or future variation.

The updated FAC definition and expanded caps will mitigate losses from large, late-career compensation increases, maintain a modest margin between fixed, statutory contributions and the cost of accruing benefits, and maintain the balance between the Foundation and Generational benefit structures. The payment of contributions on compensation in excess of the expanded caps with actual SDRS investment return at retirement provides an equitable result and additional retirement savings.

Average Annual Actuarial Losses Due to Pay Increases in Excess of 5% for FY 2013, 2014, and 2015 = $3.7 M
Approximately 32% of retirees had annual pay increases greater than 5% in one of the years prior to retirement

The Actuarial Statement: House Bill 1018 will eliminate approximately $3 million in unanticipated annual costs, reduce the cost of benefit accruals by approximately $5 million per year and reduce the liabilities of SDRS by approximately $105 million. In addition, it will enhance equity among all SDRS members.

HB 1019

An Act to revise certain provisions relating to the salary of the executive director of the South Dakota Retirement System.

The Issue

If the SDRS Board of Trustees wishes to recommend an additional salary adjustment for the executive director, the board is required to take action before May 1, which means taking action at its April meeting that is just days after the close of the Legislative Session. Also, current statutory language does not match current state salary policy for across the board increases.

The Solution

Extend the timeframe for the Board of Trustees to recommend a salary adjustment and revise statutory language to be consistent with current state salary policy.

Legislative Summary

- **The salary of the executive director would be adjusted in accordance with the state employee salary policy.**
- **The board would have until July 1 to recommend an additional adjustment that would be effective for the upcoming fiscal year if approved by the Retirement Laws Committee.**

The Background

Changes are required to be consistent with the revised state salary policy. In addition, under current law the board was required to take action at its April meeting if it chose to recommend a pay adjustment for the executive director that exceeded the state employee salary policy. The change in this bill allows the board more time after the Legislative Session to evaluate the state employee salary policy and recommend any additional adjustment to the executive director's salary if it wishes to do so. The additional adjustment would not be effective unless approved by the Retirement Laws Committee.

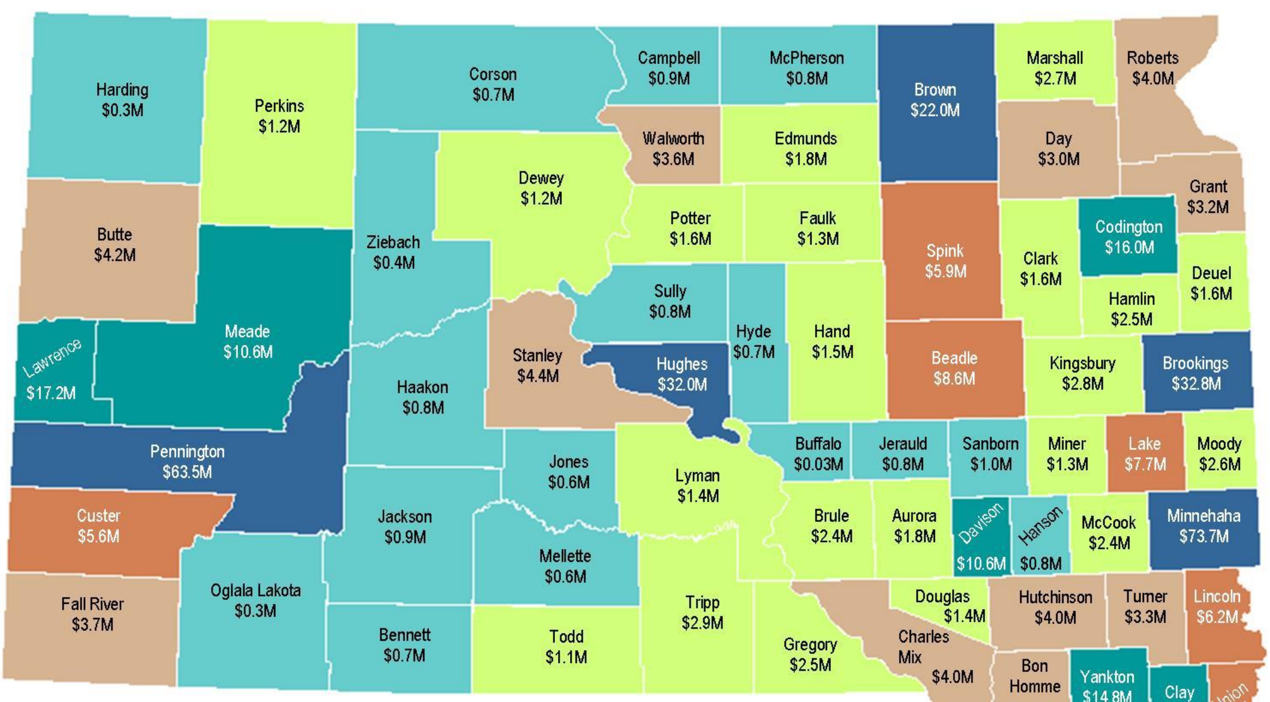
The Actuarial Statement: HB 1019 will have no impact on the liabilities or assets of SDRS.

SDRS Fiscal Year 2016 Highlights

Total Membership	**84,048**
Active Contributing Members	**39,940**
Inactive Non-contributing Members	**17,554**
Benefit Recipients: Class A and B	**26,312**
Benefit Recipients: Class C	**242**
Plan Assets	**$10,513,462,127**
Contributions	**228,533,370**
Annuitant Benefits	**487,053,001**
Refunds/Expenses	**27,388,122**
Fair Value Funded Ratio	**96.9%**

South Dakota Retirement System—Benefits Payable by County

Of the 26,312 individuals receiving Class A and B retirement benefits from SDRS, 22,590 live in South Dakota. Effective July 1, 2016, more than $500 million in annual benefit payments will be made to SDRS annuitants. Over $440 million of those payments will be distributed among South Dakota's 66 counties, positively impacting the state's economy.



$0—$1 million
$1—$3 million
$3—$5 million
$5—$10 million
$10—$20 million
$20 million +

Cement Plant Retirement Plan Statistics*
Of the 242 former Cement Plant Retirement Plan members receiving benefits, 207 live in South Dakota. Effective July 1, 2016, $4.3 million in annual benefit payments will be made to Cement Plant annuitants. Over $3.9 million of those payments will be distributed to those residing in South Dakota.

*This data is not included in the SDRS statistics noted above.

Other states and foreign countries: $60.3M

Dollar amounts have been rounded.