Dear SDRS Member:

With the recent changes in the South Dakota Retirement System (SDRS) actuarial assumptions and the associated decline in funded status, the SDRS Board of Trustees is required to propose statutory changes for the 2017 Legislative Session to bring the system back into actuarial balance. These changes are designed to modify the cost-of-living adjustment (COLA) and to address issues pertaining to compensation and the calculation of final average compensation (FAC) that result in higher benefits than intended under the Board's benefit goals. This letter provides the reasons for and the details of the proposed changes.

Recently you should have received, either by mail or email, a copy of the November 2016 issue of the *Outlook* newsletter. This newsletter contained information regarding the SDRS Board of Trustees' November 3, 2016, decision to adopt changes to the economic assumptions used to project the future costs of SDRS benefits so they are as accurate and realistic as possible. Three important economic assumptions were adjusted:

- The rate of investment return earned on SDRS assets: adjusted from 7.25% to 6.50%;
- Annual inflation: adjusted from 3.25% to 2.25%; and
- Wage growth (a portion of member compensation increases): adjusted from 3.25% to 3.00%.

The changes in economic assumptions reduced SDRS' funded status to 87 percent and increased the actuarially required contribution rate above the statutory contribution rate. As a result, the current benefit structure cannot be sustained with the statutory contributions and the SDRS Board is required by law to recommend changes so that the benefits are affordable.

In more relatable terms, think of SDRS as your household with both income and expenses. As you prepare your budget, you make assumptions about what your future income and expenses will be. It is important to review your budget regularly to ensure it is in balance and make adjustments as necessary. If the income is not sufficient to support the budget, expenses must be adjusted to bring the household budget back into balance.

In SDRS' recent "budget review," future income (contributions and investment earnings) is projected to be less than previously expected. Under the expected economic conditions, SDRS' future resources will not be sufficient to balance SDRS' long-term expenses (benefit payments to current and future retirees and the future growth of those benefit payments). With fixed statutory contribution rates, the economic reality is that SDRS benefits are not sustainable unless changes are made to rein in future benefit growth.

At its December 7, 2016, meeting, the Board proposed changes to the COLA and FAC to offset these lower income expectations and finalized legislation in these areas.

SDRS COLA

The COLA is designed to partially protect retirees from a loss of purchasing power due to inflation after retirement. The Board is proposing legislation that ties the COLA more closely to the annual inflation rate and the resources SDRS has available to pay for it.

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- If SDRS is 100% funded or better, the COLA would equal inflation (CPI-W):
    - Maximum: 3.5%
    - Minimum: 0.5%
- If SDRS is less than 100% funded, the COLA would equal inflation (CPI-W):
    - Maximum: reduced to the actuarially calculated percentage that brings SDRS' funded status back to 100%
    - Minimum: 0.5%

These proposed changes to the COLA provide a benefit structure that varies directly and automatically with SDRS experience and affordability. Under this structure, the COLA would equal inflation most of the time and has the potential to be less than inflation only when it is not affordable.

Because the COLA affects all SDRS benefit payments – those currently being paid and those paid in the future – this proposed change in the COLA is equitable to all SDRS members. Under the proposal, the new COLA structure would become effective July 1, 2018.

COMPENSATION AND FINAL AVERAGE COMPENSATION

The incidence of large, late-career pay increases has grown over the past several years, resulting in a cost issue for SDRS and an equity issue for members. While some late-career pay increases are due to a promotion, an increase in job duties, or an across-the-board pay increase, other increases are the result of systematic attempts to maximize SDRS benefits that are contrary to statutory provisions. The Board is proposing to tighten the definition of compensation for SDRS purposes and make the reporting of compensation that is inconsistent with the definition of compensation a Class 1 misdemeanor. In addition, SDRS will increase its review of employer reporting of compensation for compliance with the law.

Large increases in late-career pay can significantly increase a member's FAC, which is used to calculate SDRS benefits. The Board is proposing to phase in a longer FAC calculation period for Foundation members, as follows:

- Three-year FAC for retirements until June 30, 2021;
- Four-year FAC for retirements from July 1, 2021, to June 30, 2022;
- Five-year FAC for retirements after July 1, 2022; and
- FAC cannot be less than the June 30, 2017, FAC through June 30, 2022.

In addition, the Board is proposing to extend the application of the current 105 percent compensation cap in the member's final year to each of the years used in determining the FAC, with a phase-in period similar to that being proposed for the FAC. Under the proposed change, member and employer contributions on compensation in excess of the cap would be paid, with actual investment earnings, to the member at retirement.

PROPOSED CHANGES REQUIRE LEGISLATIVE APPROVAL

The Board's proposed changes to the SDRS COLA, definition of compensation, caps, and FAC will be introduced by the Retirement Laws Committee on behalf of the Board for consideration by the Legislature. To become law, the proposed changes must be approved by both the House of Representatives and Senate and signed into law by the Governor.

Further details regarding the proposed legislation are available on the SDRS website, www.sdrs.sd.gov. If you have any questions, please contact the SDRS office toll-free at 1-888-605-SDRS (7377). Thank you for your continued support.