SDRS Outlook

Membership Newsletter ● November 2016

Board Moves to Strengthen Economic Assumptions

The South Dakota Retirement System (SDRS) Board of Trustees' key objective is to manage the plan's benefits, including retirement, disability, and survivor benefits, within the fixed statutory contributions made by members and employers and the investment returns earned by the South Dakota Investment Council. To accomplish this objective, the Board relies on current and accurate information to project the long-term costs of benefits in order to determine SDRS' financial soundness and sustainability.

Long-term cost projections require a number of actuarial assumptions about future unknown events. The most substantial actuarial assumptions relate to the economics involved in administering a pension plan, including:

- The rate of investment return earned on SDRS assets,
- Inflation, and
- Member compensation increases

Experience Analysis

An experience analysis is conducted periodically to provide an in-depth, multi-year review comparing actual SDRS experience to each actuarial assumption. The information obtained from each experience analysis measures the "fit" of each assumption with the actual experience. The SDRS actuary uses this information to recommend changes in actuarial assumptions when appropriate.

The actuary's recommendations also consider expectations of future experience, particularly regarding SDRS' economic assumptions, that are based on professional judgment that follows rigorous professional standards of practice.

The future investment return assumption is the most powerful actuarial assumption. The long-term outlook of the South Dakota Investment Council, as well as other independent investment professionals, is a significant factor in the evaluation of the most likely future investment returns.

The goal is to adopt actuarial assumptions that individually and collectively provide the best estimate of future experience so the projections of current and future costs of SDRS benefits are as accurate and realistic as possible.

Recommended Changes in Actuarial Assumptions

Based on the current experience analysis of the economic assumptions, SDRS' actuary recommended significant changes to the economic assumptions as follows:

- Reduce the annual price inflation assumption from 3.25% to 2.25%,
- Reduce the annual investment return assumption from 7.25% through June 30, 2017, and 7.50% thereafter, to 6.50%, and
- Reduce the annual wage growth assumptions from 3.75% to 3.00%

These recommendations reflect the general consensus that inflation and investment returns are projected to remain low and the SDRS economic assumptions should be aligned with those expectations.

The Board of Trustees approved these recommendations at a meeting on November 3, 2016, for implementation

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beginning with the June 30, 2017, actuarial valuation.

Impact of Recommended Changes in Actuarial Assumptions

Changes in actuarial assumptions do not change the actual costs of SDRS. These costs will ultimately be based on actual experience. However, changes in actuarial assumptions do change the best estimate of the future costs of SDRS, provide the most realistic basis for planning, and are included in the SDRS financial statements.

These assumption changes, while necessary to project future costs with more accuracy, are significant and result in SDRS not meeting the Board's funding objectives. In short, the current SDRS benefit structure cannot be supported under these actuarial assumptions within the fixed, statutory member and employer contributions.

This economic reality creates a sense of urgency as the Board looks at ways to manage SDRS to keep it sustainable for all members.

SDRS Benefits Under Review

The changes in actuarial assumptions adopted at the SDRS Board of Trustees' meeting on November 3, 2016, result in SDRS being 87 percent funded and the fixed, statutory member and employer contributions being less than the amount needed to fund the current benefit structure. Therefore, the Board is required to recommend legislation in 2017 in order to bring SDRS back in alignment with the Board's funding objectives. After reviewing all SDRS benefits to ensure they are meeting the Board's benefit and cost objectives, the Board determined that the SDRS Cost-of-Living Adjustment (COLA) and Final Average Compensation (FAC) should be addressed.

Inflation and the SDRS COLA

The goal of the COLA is to partially protect retirees from a loss of purchasing power due to inflation after retirement. Over the past 30 years, SDRS has provided a COLA significantly in excess of inflation and in excess of the Board's goal. That trend is expected to continue under the current COLA structure. The ongoing costs of the current COLA design are significant and, based on the estimates under the newly adopted actuarial assumptions, not affordable.

As a result, the Board is considering a new COLA design that ties the COLA more closely to the annual inflation rate and the resouces SDRS has available to pay for it. Limiting the COLA in this manner will bring future costs in line with what can be afforded. Since the COLA affects all SDRS benefit payments—those currently being paid to benefit recipients as well as those to be paid to future benefit recipients—a change in the COLA would be equitable to all SDRS members.

Final Average Compensation

All SDRS benefits are calculated using a member's Final Average Compensation. Your Final Average Compensation, or FAC, is determined by taking the average of your highest 12 consecutive calendar quarters of pay out of your last 40 quarters of service (three years of the last 10 years of compensation), subject to a cap for extraordinary payments in your final year or quarter of active SDRS membership. For most members, the final three years of pay are typically the highest.

Basing SDRS benefits on FAC is important to ensure an adequate income replacement during retirement. However, it can be costly because it provides benefits based on the member's compensation close to retirement, which may be significantly higher than the average salary earned over the course of the member's entire career.

Member and employer contributions, along with investment earnings, provide the funding for SDRS benefits. When a member receives a salary increase, SDRS contributions from both the member and the employer also increase. Adequate funding for SDRS benefits is dependent on predictable compensation

SDRS Travel Schedule

DATE	EVENT	LOCATION	ADDRESS	TIME
12/05/2016	Women & Financial Planning Workshop	Spearfish, Holiday Inn	I-90 Exit 14	5:15—7:30 PM
12/06/2016	Retiree Forum	Brookings, Swiftel Center	824 32nd Avenue	3:00—4:00 PM
12/06/2016	Pre-Retirement Planning Workshop	Brookings, Swiftel Center	824 32nd Avenue	5:30—8:00 PM
12/12/2016	Individual Counseling Sessions	Martin, Library Community Room	101 Main Street	2:00—8:00 PM 30-minute sessions available
12/14/2016	Early & Mid-Career Workshop	Brookings, Swiftel Center	824 32nd Avenue	6:00—8:00 PM

increases throughout a member's career, coupled with sufficient time for the investment earnings to pay for the cost of higher benefits resulting from higher compensation.

Many members receive significant compensation increases early in their careers as they progress in their jobs. Promotions, job changes, and across-the-board pay raises may also significantly increase their compensation by the middle of their careers or even later. For example, the recent teacher pay increase as a result of the sales tax increase, which SDRS supported, resulted in many late-career teachers seeing a boost in pay. However, most members have progressed in their job by their late careers and thus receive smaller, more predictable compensation increases as they approach retirement.

In contrast, some members receive late-career compensation increases resulting from intentional restructuring of pay or the attempt to include pay not previously considered in compensation, such as early retirement incentives, insurance premiums, etc. This is done solely to enhance the FAC used in calculating SDRS retirement benefits, which creates subsidies that can affect the benefits for all SDRS members.

The practice of intentionally restructuring pay, resulting in unintended and excessive benefits to some members, is referred to as "spiking." Spiking creates subsidies, inequities, and higher costs for SDRS. In addition, spiking tends to occur more frequently with higher-paid members, which exacerbates the subsidies and costs borne by SDRS and its members.

These late-career compensation increases have resulted in higher costs for SDRS of between 5 and 10 million dollars each year and these costs are growing. Even more importantly, a very high percentage of these costs result from a very few members. For example, in 2015, late-career compensation increases for one percent of the retirees resulted in 44 percent of the unanticipated costs to SDRS.

The SDRS Board of Trustees is evaluating solutions to the late-career spiking issues. Initiatives under consideration include:

- Adding more emphasis on communicating and enforcing the provisions of South Dakota Codified Law and the auditing of employer practices
- Extending the caps that limit the amount of compensation increases considered in FAC
- Changing the FAC calculation process

Upcoming Board Meetings

- December 7, 2016 at View 34 in Pierre, SD
- April 5 or 6, 2017 at View 34 in Pierre, SD
- June 14, 2017 with SDIC in Sioux Falls, SD
- September 6 or 7, 2017 at View 34 in Pierre, SD
- December 6 or 7, 2017 at View 34 in Pierre, SD

South Dakota Retirement System
P.O. Box 1098
Pierre, SD 57501

SHIINE: Helping You Understand Medicare

SHIINE is a **FREE**, unbiased, volunteer-based service which assists Medicare beneficiaries with problems or questions regarding Medicare benefits, including comparing your Part D (prescription drug) plan options.

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South Dakota SHIINE Regional Offices

Western: 1.877.286.9072
SHIINE@westriversd.org

Central: 1.877.331.4834
SHIINE@centralsd.org

Eastern: 1.800.536.8197
SHIINE@activegen.org

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