



# A Benefit Design for a New Generation

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SDRS Generational Benefits  
for New Members  
Effective July 1, 2017





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# Introduction

While the South Dakota Retirement System (SDRS) has evolved since 1974 to include numerous innovative benefit changes, the following long-term objectives continue to guide the goals and recommendations of the SDRS Board of Trustees:

- Maintain actuarial soundness and sustainability
- Provide adequate benefit levels
- Manage the system with fixed employer and member funding
- Administer the system and manage the investments efficiently and cost effectively

The progress of SDRS in meeting those general objectives, as well as more detailed goals, is documented in the SDRS publication *The Guiding Principles, Objectives, and Goals of a Consolidated System*.

This white paper documents the rationale and objectives for an important additional step forward in meeting those objectives—a new benefit design for the future generations of SDRS members and the expected long-term outcome of this design. The new benefit design does not result in lower costs for new members, subsidies to current members, or a reduction in benefits to meet a financial need. It does represent a redistribution of benefits.

***These benefits are referred to as **Generational benefits** and only apply to new SDRS members joining the system on and after July 1, 2017. SDRS benefits for current members are referred to as **Foundation benefits** and have not changed.***

## Key Positions Adopted by the SDRS Board of Trustees

Before getting into the details of the Generational benefits, a summary of the key positions of the Board that guide its recommendations for benefit design include:

- The SDRS retirement model is based on defined benefit features because they deliver the best value to the members at retirement. In addition, SDRS includes features most commonly found in defined contribution plans to provide meaningful benefits for employees who leave before retirement. The result is a hybrid retirement system.
- The hybrid features of SDRS are desirable and sound. The present balance between benefits for long-term and short-term members is appropriate.
- The Board is committed to providing income replacement benefits in accordance with its long-term goals to give SDRS members and their families the opportunity to achieve financial security at retirement, disability, or death.

These key positions provide the framework for the Generational benefits.

# Identifying the Issues

SDRS is a well-funded retirement system with no unfunded liabilities. Maintaining this rare and important accomplishment is a key funding objective of the Board and the State of South Dakota.

As noted in *The Guiding Principles, Objectives, and Goals of a Consolidated System*, the Board continues to plan for the challenges of the future, including:

- Maintaining and improving the fully funded status of SDRS to weather economic downturns
- Adjusting to lengthening life expectancy and increasing market volatility
- Evolving with changes in SDRS membership and employer workforce issues

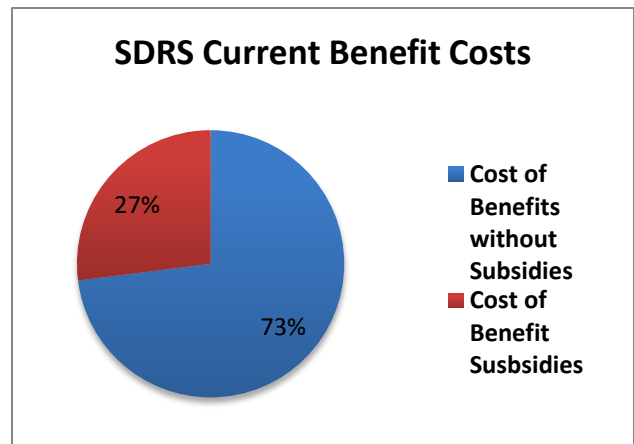
The Board has adopted a detailed Funding Policy to meet its most important fiduciary responsibility – the continued actuarial soundness of SDRS. Accordingly, the Board recommends benefits for SDRS members that can be provided within the resources available. However, fixed resources and challenging economic times dictate the benefit design to be as efficient as possible so that the Board’s benefit adequacy goals can be met for all members.

The Board has spent the last several years examining every detail of the current SDRS benefit provisions, the costs of each benefit, the best practices of similar systems, as well as projections of the future funded status of SDRS under different economic conditions. The results of this analysis have shown that:

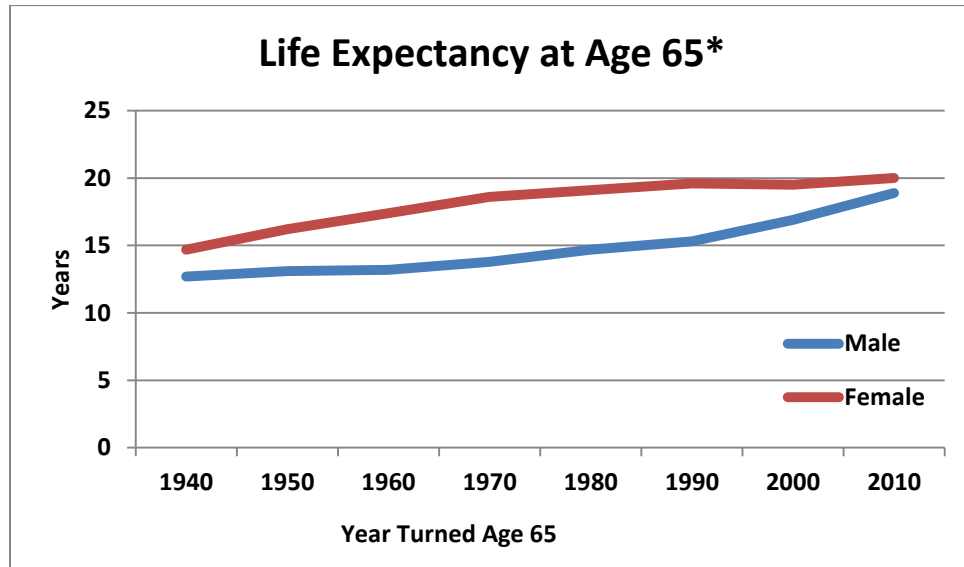
- A number of current SDRS benefit practices provide significantly more valuable benefits to only a portion of SDRS members, creating subsidies that amount to 27% of the total costs.

The most significant subsidies are the retirement benefits payable before Normal Retirement age (65 for most SDRS members) and to married members. On average, members receive a retirement benefit that is:

- 25% more valuable than a Normal Retirement benefit if they retire at Special Early Retirement
- 10% more valuable than a Normal Retirement benefit if they retire at Early Retirement
- 10% more valuable if the member is married at retirement

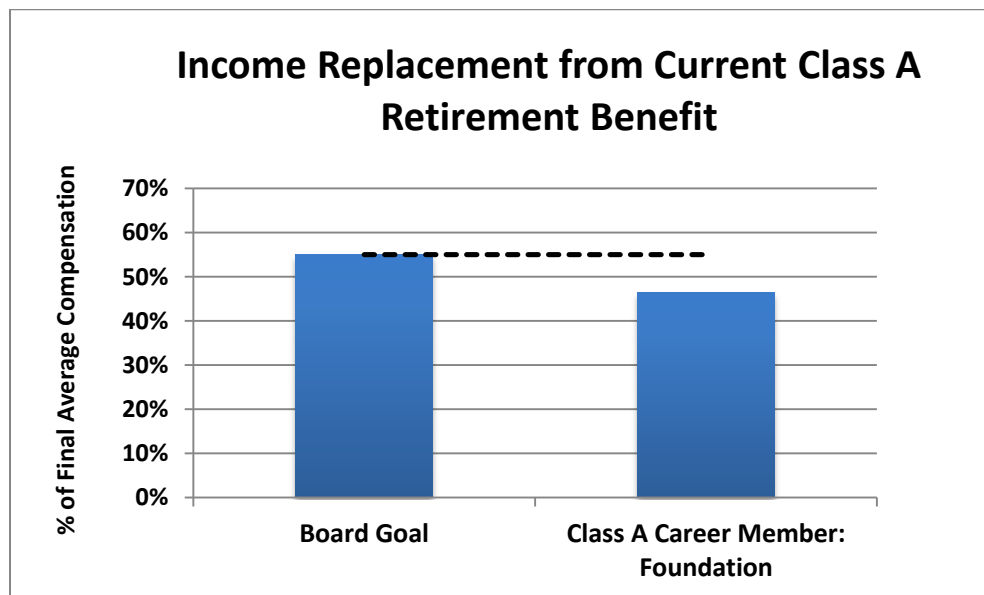


- Employees are living longer and therefore the cost of lifetime benefits has increased.



Over the history of SDRS, life expectancy at age 65 has increased by over five years for males and over two years for females. Current studies indicate life expectancy is expected to continue to improve in the future.

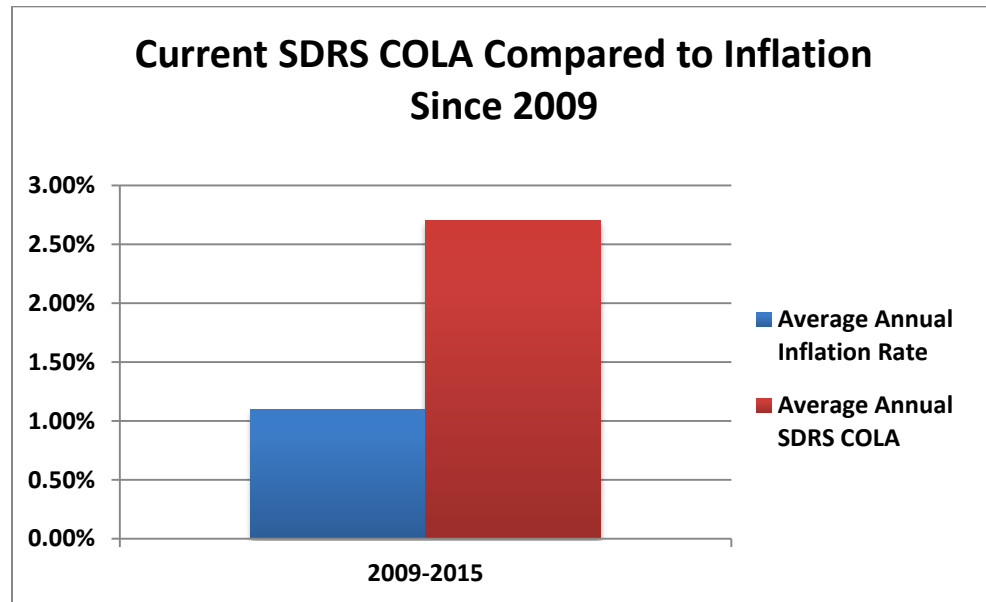
- The Class A retirement benefits do not currently meet the Board’s 55% income replacement goal (% of pay at retirement from SDRS) for career members (30 years of service) and are less than typical practices.



\*Source: Social Security Administration

The current SDRS retirement benefit is paid for the lifetime of a single member and includes a 60% survivor benefit to the spouse of a married member.

- The SDRS Cost of Living Adjustments (COLA) after retirement do not adjust to low inflation periods and have been more than double the rate of inflation since 2009.



- Most SDRS benefits are fixed and do not vary with the investment results of the SDRS trust fund.
- SDRS benefits for short service members are unique, not costly, and consistent with the Board's objectives.
- SDRS benefits are based on a three-year average pay (Final Average Compensation), while the most common practice is a five-year average. A five-year average would also help control the cost impact of higher than anticipated pay at retirement.
- Changes to the current practices would increase the chances of SDRS meeting the Board's funding objectives, statutory requirements, and continued sustainability and decrease the chances of future benefit reductions or other corrective actions.



## Objectives/Strategies for Generational Benefits

After identifying and analyzing the issues, and prior to considering possible changes to address those issues, the Board established the following objectives for Generational benefits:

- **Sustainability:** Increase likelihood of sustainability and avoidance of corrective actions in the future
- **Workforce:** Align benefits to better recognize employers' workforce issues
- **Sufficiency:** Meet income replacement goals for career members
- **Equity:** Maintain equity with current members

Those objectives led to the following strategies:

- Restructure benefits without requiring additional contributions
- Recognize increasing life expectancy
- Eliminate or decrease subsidies, inequities, and unanticipated costs
- Utilize the savings to add more variable benefits and enhance the hybrid features of SDRS
- Consider national practices and materiality

## Summary of Generational Benefit Design Changes

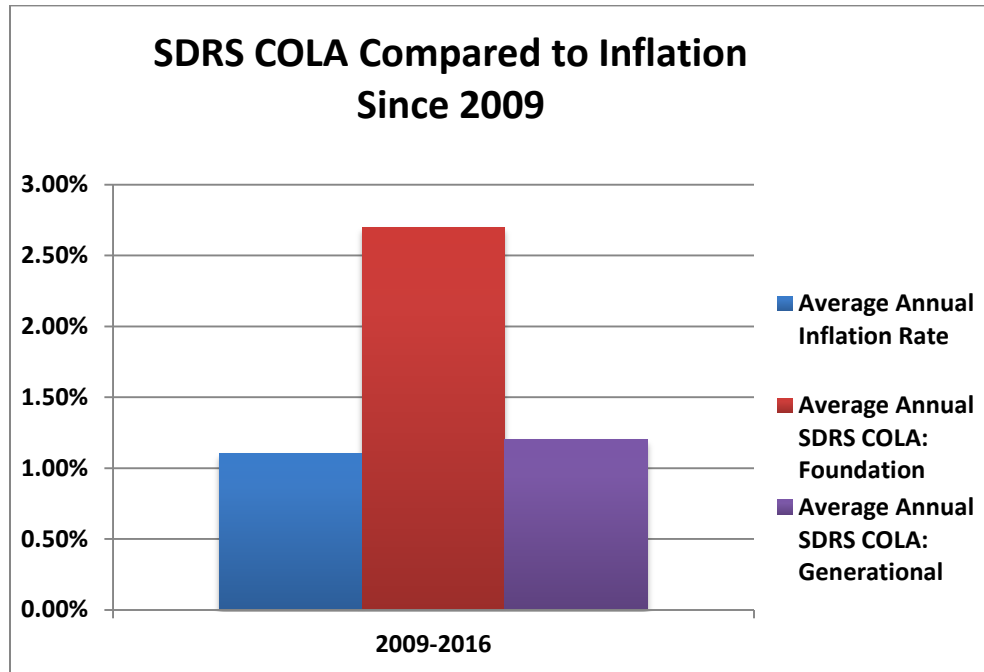
To address the issues and meet the Board's objectives, the following changes in benefit design were recommended for Generational members:

<b>Generational Benefit Design Changes</b>	<b>Objectives Addressed</b>
<b>Eliminate unreduced benefits payable before Normal Retirement Age</b>	<ul style="list-style-type: none"> <li>• Sustainability</li> <li>• Equity</li> <li>• Workforce</li> </ul>
<b>Actuarially reduce benefits payable at Early Retirement</b>	<ul style="list-style-type: none"> <li>• Sustainability</li> <li>• Equity</li> <li>• Workforce</li> </ul>
<b>Eliminate Alternate Formula</b>	<ul style="list-style-type: none"> <li>• Equity</li> </ul>
<b>Provide spouse benefit after retirement at member cost</b>	<ul style="list-style-type: none"> <li>• Sustainability</li> <li>• Equity</li> </ul>
<b>Limit COLA to rate of inflation with a 1% minimum and current maximums</b>	<ul style="list-style-type: none"> <li>• Sustainability</li> <li>• Equity</li> </ul>
<b>Increase Final Average Compensation Period to five years</b>	<ul style="list-style-type: none"> <li>• Sustainability</li> <li>• Equity</li> </ul>
<b>Increase Class A retirement benefits and maintain Class B benefits</b>	<ul style="list-style-type: none"> <li>• Sufficiency</li> <li>• Equity</li> </ul>
<b>Increase Normal Retirement Age and Early Retirement Age by two years</b>	<ul style="list-style-type: none"> <li>• Sustainability</li> <li>• Equity</li> <li>• Workforce</li> </ul>
<b>Add a Variable Retirement Account</b>	<ul style="list-style-type: none"> <li>• Sustainability</li> <li>• Sufficiency</li> <li>• Equity</li> </ul>

The Generational benefit design eliminates all early retirement subsidies, provides equal benefits for single and married members, and restructures other practices to eliminate subsidies, inequities, or unanticipated costs.

In addition, the SDRS COLA for Generational members is limited to the rate of inflation, but not less than 1% or more than 3.1% per year depending on SDRS's funded status.

The chart on the next page shows the average annual inflation rate since 2009 and compares it to the average COLA for Foundation members for that same period and the average Generational COLA if it had been in effect during that time frame.

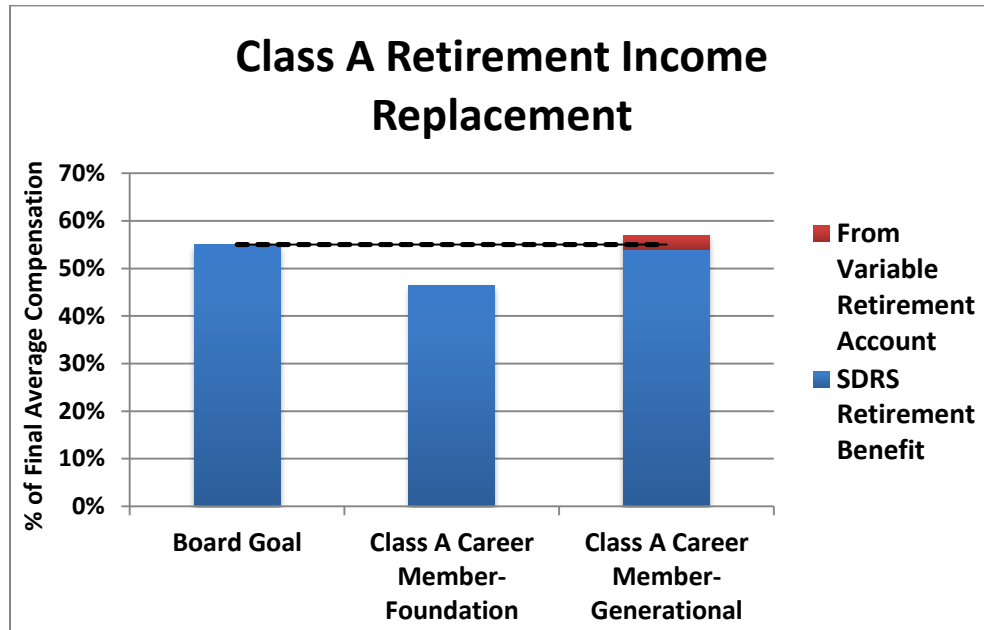


Increased life expectancies have been addressed in the Generational benefit design by increasing the eligibility ages for Normal and Early Retirement by two years. The Normal Retirement age for Social Security benefits also increases gradually to age 67 for any employee born in 1960 or later.

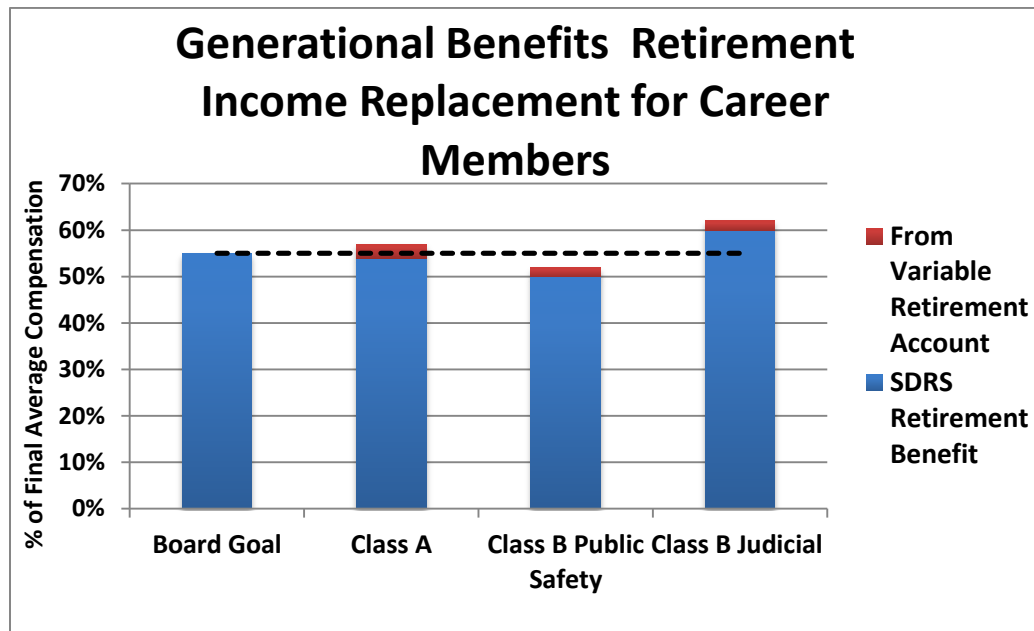
In short, the elimination of all subsidies and increases in retirement ages in the Generational benefits results in:

- A more equitable benefit structure for all SDRS members; and
- The resources to create a new benefit, called the Variable Retirement Account, for Generational members, as well as increase Class A Generational retirement benefits to meet the Board’s income replacement goal for career members (55% for a member with 30 years of service).

Both SDRS retirement benefits and the additional lifetime benefit that could be purchased with the Variable Retirement Account are shown below. The balance in the Variable Retirement Account assumes a 1.5% of pay Variable Retirement Contribution each year, a 7.5% annual investment return, and the purchase of an SDRS Supplemental Pension Benefit at current rates. Foundation benefits are paid for the lifetime of a single member and include a 60% survivor benefit for married members. Generational benefits are payable for the lifetime of the member only unless the member elects a reduced benefit that provides a survivor benefit to the spouse.



The Variable Retirement Account provides additional funds to meet the Board’s income replacement goal for all Generational SDRS career members. Note: career members are those with 25 years of service at retirement for Class B Public Safety and 20 years for Class B Judicial members.



The Generational design also retains the current benefits for short service members and responds to employer work force needs to retain experienced and qualified employees by eliminating the financial incentives to retire early.

A detailed summary of the Generational benefits is included in the Appendix.

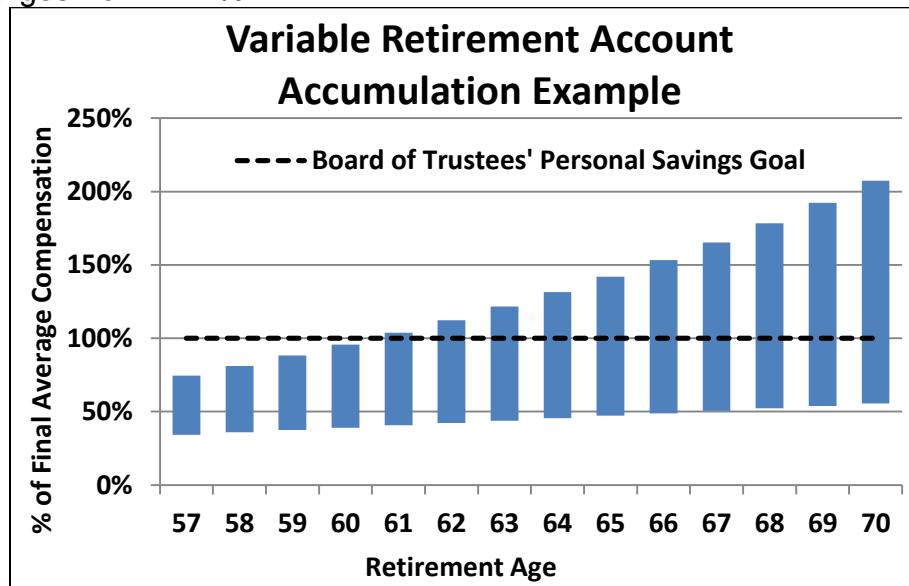
# Variable Retirement Account

The Variable Retirement Account is a key feature of the Generational benefits and allows members to directly participate in the investment success of the South Dakota Investment Council.

Briefly, the Variable Retirement Account is:

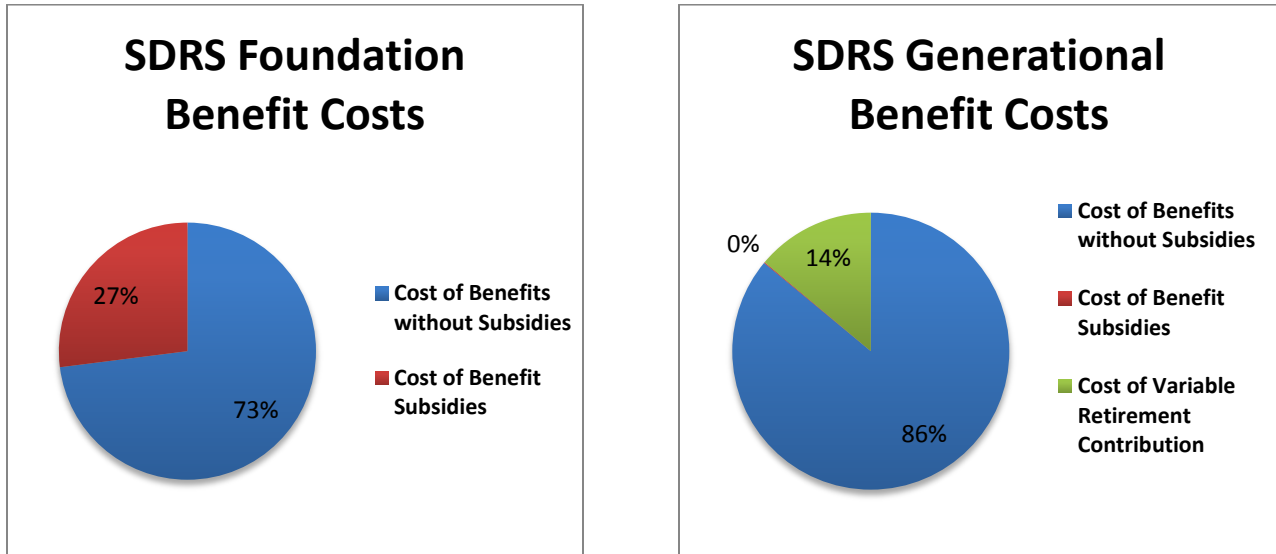
- Funded through an allocation of part of the employer contributions paid to SDRS. This Variable Retirement Contribution will initially be 1.5% of pay for all contributing Generational members, but may change in the future.
- Credited with the actual investment return of the fund. The balance of the Variable Retirement Account will not be less than the accumulated Variable Retirement Contributions.
- Paid at retirement, death, or disability, but forfeited if a member elects to receive a refund of contributions at termination.
- Payable as a lump sum, can be rolled over to an eligible retirement account or the SDRS Supplemental Retirement Plan, or used to purchase a Supplemental Pension Benefit (at retirement only).

The Board's benefit goals include personal retirement savings of at least one times annual pay to supplement monthly lifetime benefits available from SDRS and Social Security. The amount of the Variable Retirement Account will depend on the amount of funding, investment results, and years of participation and will help members meet, or potentially exceed the savings goal. The following example shows Variable Retirement Account balances for a Generational member who becomes a member at age 35 and assumes the 1.5% Variable Benefit Contribution is made each year and earns an annual investment return that ranges from 4-11%.



## Cost Outcomes and Sustainability Improvements

The Generational benefit design will meet all the Board's objectives while it restructures benefits at the same cost as the Foundation benefit structure. New members with Generational benefits will not subsidize the cost of benefits for Foundation members.



The sustainability of SDRS is improved by these Generational benefit design changes in the following ways.

- A portion of the benefits (the Variable Retirement Account) will directly vary with the investment results of the System, thus lowering the SDRS liabilities when times are bad and increasing them during good times.
- The COLA will be tied to the rate of inflation, with a minimum of 1% and a maximum of 3.1%, depending on SDRS's funded status.
- The portion of contributions (1.5% of pay) used to fund the Variable Retirement Account could be reduced or suspended if the minimum SDRS statutory funding objectives are not met. However, reductions in other benefits for all Foundation and Generational members would likely also be considered in such circumstances.
- SDRS will no longer be subject to the risk of actuarial losses due to members retiring earlier than expected, since the subsidy for early retirement has been removed.

Because all these changes only apply to new members, SDRS's improved sustainability will be gradual. Over decades, as SDRS becomes fully transitioned to a Generational membership, the impact of a one-year severe investment loss when SDRS is fully

funded will be lessened because:

- SDRS will be able to sustain a marginally worse investment loss of about 2% before crossing the corrective action thresholds.
- If corrective actions are necessary, the amount of those corrective actions would be reduced by approximately 40%.
- The resources available to meet any future Unfunded Liabilities resulting from unfavorable experience will be greater and require about 2/3 less time to pay off.

## **Maintaining and Enhancing the SDRS Retirement Model**

The Board will continue to evaluate the SDRS retirement model for both Foundation and Generational members and recommend changes to the Legislature as needed to meet its goals and objectives.

If future benefit improvements are recommended by the Board (in accordance with its policies), additional funding of the Variable Retirement Account will be the preferred benefit improvement approach for active Generational members.



## Summary

The Generational benefit design with the Variable Retirement Account results in an equitable benefit structure for the new generation of SDRS members.

- The Generational benefits only apply to new SDRS members.
- The Generational benefit design changes reflect a restructuring of benefits to meet specific objectives at the same total cost structure as the Foundation benefits.
- SDRS remains one retirement system with no changes in employer or member funding, but provides different benefit structures for Foundation and Generational members.

# Appendix

## Summary of Generational Benefits

### Retirement Eligibility:

- Normal Retirement Age: 67/57 (Class A and Class B Judicial/Class B Public Safety)
- Early Retirement Age: 57/47 (Class A and Class B Judicial/Class B Public Safety) with a 5% per year reduction
- No Special Early Retirement
- Three-year Vesting

### Benefits:

- 1.8% benefit formula for Class A
- 2% and 3.3%/2% benefit formulas for Class B Public Safety and Class B Judicial, respectively
- Five-year Final Average Compensation
- No Class A Alternate Formula
- No Level Income option
- Variable Retirement Account to supplement base benefits at retirement, death, or disability
- Same disability, pre-retirement survivor, and termination (refund) benefits as Foundation members

### Post-Retirement Benefits

- Annual COLA equal to the rate of inflation, but no less than 1% or more than:
  - 3.1% if SDRS Fair Value Funded Ratio is 100% or more
  - 2.8% if Funded Ratio is more than 90% but less than 100%
  - 2.4% if Funded Ratio is more than 80% but less than 90%
  - 2.1% if Funded Ratio is less than 80%
- If member elects a reduced benefit at retirement, 60% or 100% of reduced benefit payable to surviving spouse. Otherwise, the benefit is payable for the life of the member only.





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