SDRS
SOUTH DAKOTA
RETIREMENT SYSTEM

A SYSTEM GUIDE TO PLANNING FOR THE UNEXPECTED

December 2020

This planning guide has been developed in 2020 to provide a starting place for future Board of Trustee deliberations if unexpected conditions occur. It does not represent a definitive plan of action and will be reviewed and updated in the future as advisable.

Introduction

The SDRS Board of Trustees has devoted considerable time and effort in 2020 reviewing the past experience of SDRS in all economic periods and evaluating the impact of varying future economic conditions on SDRS. The Board has considered numerous benefit and other changes that may be recommended to responsibly manage SDRS during these conditions. Based on these deliberations, the Board has developed a set of objectives, action plans, and recommendations the Board would consider if future conditions warrant them.

This planning guide documents that review process and is intended to provide a starting point for the Board's future actions if, and when, necessary.

Importance of Planning

SDRS has been successful because of the absolute commitment by the Board of Trustees to manage SDRS within the resources provided by fixed statutory contributions and to embrace its fiduciary responsibility.

Planning for the unexpected includes consideration of benefit improvements during favorable economic periods as well as benefit reductions during unfavorable economic times.

This planning guide confirms the conditions in which Board action may be advisable, the current likelihood those conditions will exist, and the actions that would be considered at that time.

Summary of Findings

The Board reviewed the SDRS history during its almost five decades of existence and confirmed the following:

- A continuing commitment to fixed contributions is essential and has been the foundation for the success of, and confidence in, SDRS.
- Favorable experience (generally due to investment returns) has provided the resources for numerous benefit improvements—including 11 improvements to the SDRS benefit formulas.
- Past benefit improvements have been key to meeting the SDRS benefit adequacy goals.
- Benefit changes have also been required due to unfavorable experience and have primarily resulted in the reduction or elimination of subsidies or a reduction of benefits in excess of the Board's adequacy goals.
- Future benefit reductions have serious consequences to SDRS members and may result in a failure to meet the SDRS benefit adequacy goals.
- The SDRS COLA varies with both inflation and what is affordable and is a key element in the SDRS benefit design.
- SDRS is expected to remain fully funded in most economic conditions, but not all.
- Conditions can change rapidly and substantially due to the volatility of investment markets.
- Economic downturns may be more frequent and more severe than previously thought.
- A recovery after a severe downturn may be expected, but the timing and strength is unknown.
- The South Dakota Investment Council's disciplined approach has resulted in smaller investment losses during downturns and more rapid recovery.
- The increasing maturity of plans like SDRS exacerbates the impact of downturns.
- Adding additional substantive fixed liabilities to SDRS is unwise.

- SDRS cannot afford unintended subsidies.
- Benefit increases once granted have in the past been difficult to reverse; as a result, future increases may need to be clearly identified as payable only as long as affordable.
- Decisions should not be made solely on the results of the most recent actuarial valuation since that reflects a snapshot of conditions existing only on June 30.
- The current economic conditions and future outlook result in a higher probability that the Board will need to consider recommendations for future benefit reductions rather than benefit improvements as summarized in Exhibit 1. However, planning should consider both the good and bad times.

Planning for the Good Times

The Board will be guided by the following policies and objectives in considering recommendations for future benefit improvements. Any Board of Trustee recommendations for benefit improvements must be approved by the Legislature and the Governor.

Board Policy for Consideration of Benefit Improvements

Benefit improvement recommendations will only be considered by the Board if the following conditions exist:

- The Fair Value Funded Ratio (FVFR) is at least 120% after fully funding the benefit improvement.
- The cost of the benefit improvement is:
    - Fully funded
    - Less than the sustained net investment gains

The Board confirmed this policy is an appropriate standard for considering benefit improvements based on the design of the SDRS variable COLA.

Objectives for Recommended Benefit Improvements

- Consider any shortfalls compared to long-term benefit objectives.
- Include active, inactive, and retired members in benefit improvements.
- Avoid substantive additional fixed benefit obligations.
- Maximize the risk-mitigation impact of any benefit improvements.
- Consider unimproved service (service after 2008).
- Treat active, inactive, and retired members consistently.
- Consider other factors after the most recent June 30 actuarial valuation, including the current investment outlook, before recommending changes.
- Be cautious.

Potential Recommended Benefit Improvements

- Active and inactive members:
    - Fund the Variable Retirement Account
    - Consider an allocation formula based on pay, all service, and unimproved service

- Retired members:
    - One-time COLA adjustment if COLAs since 2010 have not matched inflation
    - Restoration of benefits temporarily reduced due to corrective actions
    - One-time payment, or a limited number of payments subject to continuing affordability
    - Additional monthly payments subject to variable COLA, which may be paid as a separate amount and contingent on continuing affordability

Planning for the Bad Times

The Board will be guided by the following statutory requirements, policies, and objectives in considering recommendations for future benefit reductions. Any Board of Trustee recommendations for benefit reductions must be approved by the Legislature and the Governor.

SDCL 3-12C-228

The Board is required to recommend corrective actions if:

- The SDRS FVFR is less than 100%, or
- The minimum actuarial requirements exceed the fixed contribution rate.

Note the Board recommendations shall include "the circumstances and timing for any corrective actions."

Initiatives Identified

As part of the planning process, the Board identified two initiatives that would minimize the risk of future required corrective action recommendations:

- Reduce the minimum variable COLA to 0%.
- Analyze the ability and advisability of permitting a limited unfunded liability expected to be fully funded by the contribution margin (the excess of fixed statutory contributions over the cost of current benefits) in a very short time (10-12 years as noted below).

These initiatives would together substantially reduce the likelihood of additional required corrective action recommendations as shown in Exhibit 2. The one-year likelihood of additional required corrective action recommendations as of June 30, 2020 would be reduced from 24% to 7% if these initiatives are implemented.

Proposed legislation will be presented by SDRS in 2021 to implement the COLA change.

SDRS is committed to maintaining a 100% funded status but that objective is unlikely to be achieved in all economic periods. The unfunded liability initiative would be considered and reevaluated only after the COLA has been reduced to zero. Under current conditions, the FVFR under this initiative would be at least 95% and the unfunded liability would be expected to be fully paid over a period of 10-12 years or less.

The initiatives have been reviewed with stakeholders, including the rating agencies, who stressed their comments did not represent an official opinion or endorsement of the initiatives. However, the following general points were made by the various parties:

- The fully funded status of SDRS is highly valued, rare, and a source of pride.
- It is not realistic to expect SDRS, or any plan, to be fully funded in all conditions.
- South Dakota has worked hard to successfully manage its retirement system and maintain a well-funded system. These initiatives are viewed as part of that on-going effort.
- The SDRS statutory requirements outlining funding standards and corrective action recommendation requirements are strengths.
- The SDRS variable COLA structure is an effective design.
- The South Dakota bond rating is not necessarily predicated upon SDRS maintaining a 100% funded status in all conditions. In fact, the rating agencies currently make their own adjustment to the SDRS funded status based on a lower discount rate, which results in SDRS being less than 100% funded and therefore having unfunded liabilities in their analysis.

The unfunded liability initiative would be a potential Board response to the recommendation requirements of SDCL 3-12C-228 prior to any additional benefit reductions. This would allow SDRS to temporarily fall short of the statutorily required 100% funded status under extraordinary conditions. It provides a balance between meeting very ambitious funding objectives after a severe economic downturn and providing adequate benefits.

This initiative would be recommended by the Board only after current input from all interested parties (including rating agencies) and contingent upon approval by the Legislature and the Executive Branch as part of their SDRS oversight responsibilities.

Objectives for Recommended Benefit Reductions

Even after both of these initiatives, the possibility (although relatively small) still exists that additional benefit changes would be required. If so, the following objectives have been established by the Board for any necessary additional recommended benefit reductions:

- Protect accrued benefits and the retirement eligibility terms for them.
- Expand the variable benefit concept.
- Provide permanent changes in practices if they result in sound long-term policy.
- Avoid irreversible changes in other benefit practices.
- Limit benefit reduction to minimum required to satisfy funding standards.
- Consider other factors after the most recent June 30 actuarial valuation, including the current investment outlook, before recommending changes.
- Pair additional benefit reductions with permissible additional unfunded liabilities that can be funded by higher contribution margins.
- Keep recommendations as simple, flexible, and equitable as possible.

Potential Recommended Benefit Reductions

- Consider one or more of the following as needed:
    - Reduce benefits based on future service by 10%
    - Expand final average compensation period to 10 years

    - Provide Generational benefit structure for all future service and suspend contributions to Variable Retirement Account
- Analyze the ability and advisability of permitting additional unfunded liabilities that can be fully funded by additional contribution margin resulting from additional benefit reductions. This would result in a funded ratio less than 95% but would eliminate the unfunded liability in the same 10-12 year period.
- Structure changes to revert back to current benefits when and if feasible.
- If above changes are not adequate, very severe additional changes may be required such as:
    - Freeze accrued benefits and base future benefits on pay earned each year (career average benefit)
    - Reduce accrued benefits

Exhibit 1

June 30, 2020 Preliminary 1-Year Outlook with Current Provisions

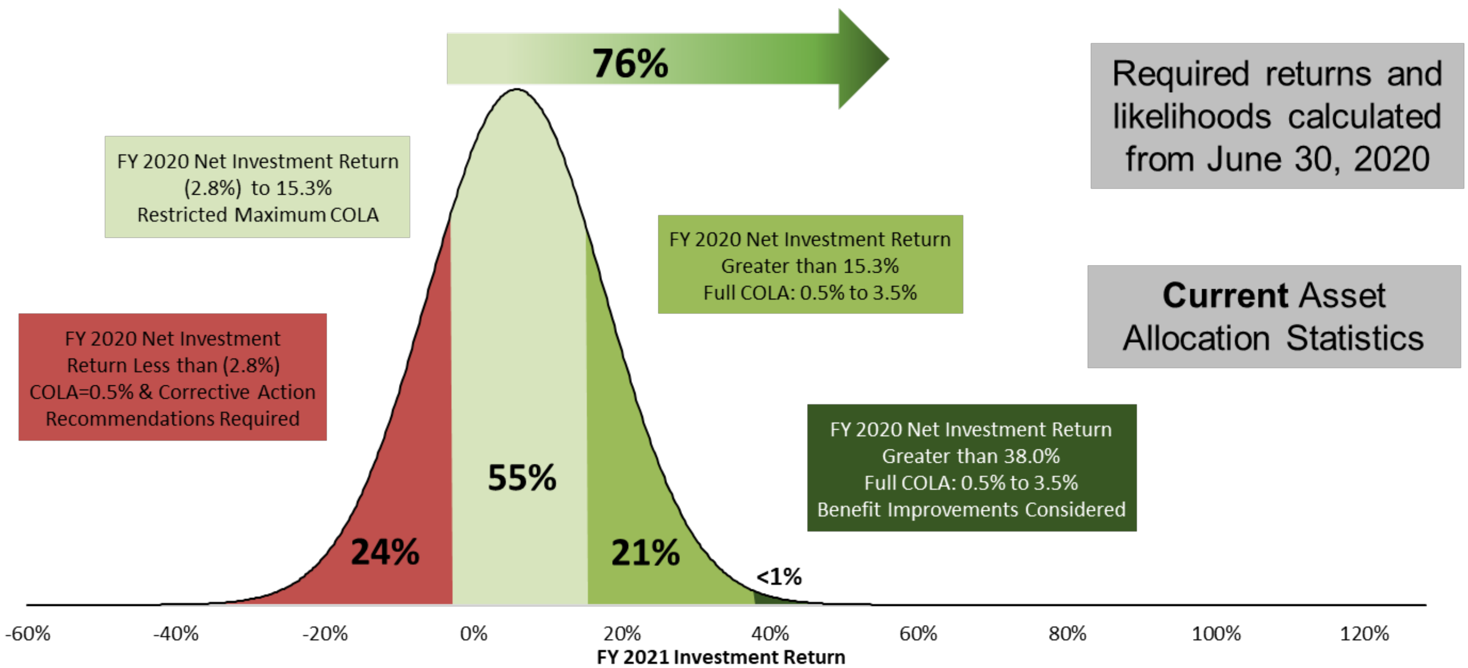
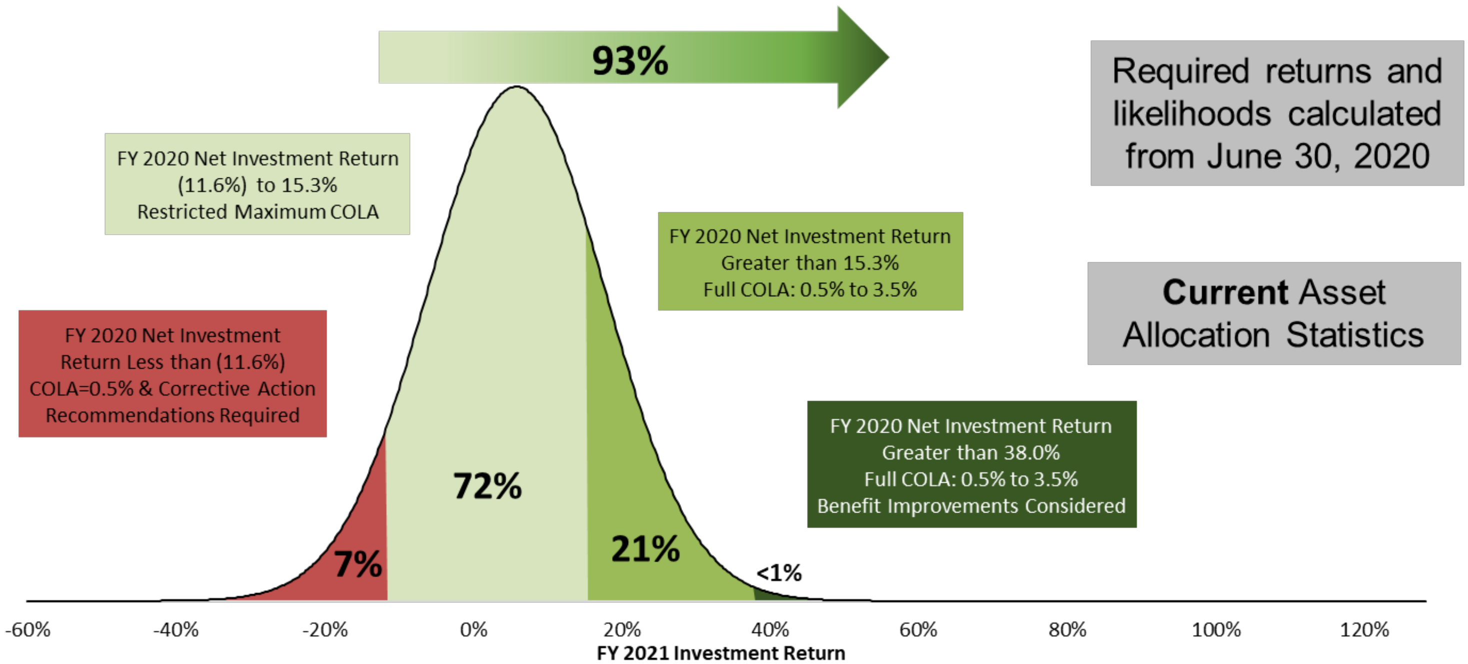


Exhibit 2

June 30, 2020 Preliminary 1-Year Outlook with 0% Minimum COLA and Limited Unfunded Liability



Summary

This planning guide reflects the Board's responsibility to manage SDRS during all economic periods and outlines a framework for potential Board actions if unexpected events occur. It is intended to provide a starting point for Board considerations if the conditions described in this document indicate recommendations for changes are advisable.

This plan should be reviewed periodically and updated as advisable based on continuing experience, evolving information, and additional analysis.