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November 26, 2014

Senator Dick Dever, Chairman
Employee Benefits Programs Committee
North Dakota Legislative Assembly
600 East Boulevard
Bismarck, ND 58505-0360

Re: **Technical Comments – Bill Draft No. 15.0176.04000**

Dear Senator Dever:

The following presents our analysis of Bill Draft No. 15.0176.04000:

Systems Affected: North Dakota Public Employees Retirement System (PERS) Hybrid Plan and Defined Contribution Plan.

Summary: The proposed legislation would close State employee participation in the PERS Hybrid Plan, which is a defined benefit (DB) plan, requiring new State employees first hired after December 31, 2015 to participate in the Defined Contribution (DC) Plan.

- New employees of political subdivisions would still be eligible to participate in the Hybrid Plan. Currently, political subdivisions represent approximately 50% of the active population of the Main System.

- Temporary State employees hired after December 31, 2015 would only be able to participate in the DC Plan.

- State Employees currently participating in the Hybrid Plan and those hired before January 1, 2016, may make an irrevocable election to transfer to the DC Plan during the last six months of 2016.

- Contribution rates for new State employees in the DC Plan would be the same contribution rate as statutorily required under the defined benefit plan applicable to the appropriate employee group.

- The vesting period for employees in the DC Plan would be changed to 100% vesting after one year of service.

- The bill draft would not affect current or future Supreme Court or district court judges, employees eligible to participate in the National Guard retirement plan or the law enforcement plan, employees of a political subdivision, or employees of the State Board of Higher Education and state institutions under the jurisdiction of the board that are participating in the TIAA-CREF retirement plan.

- The proposed bill does not provide for a funding mechanism to address the funding issues for the Hybrid Plan that would be created by the changes made by the bill. According to the report from prepared by Legislative Council staff:

  The Government Finance Committee approved a separate bill draft to address any unfunded liabilities of the defined benefit plan resulting from the bill draft to close the defined benefit plan to new state employees. The separate bill draft establishes a School Construction Assistance Loan Fund and a Public Employee Retirement Stabilization Fund. The funds in the Public Employee Retirement Stabilization Fund would be available to offset any unfunded liability of the Main State Employee Defined Benefit Retirement Plan. The State Investment Board would be responsible for investing the Public Employee Retirement Stabilization Fund. The bill draft includes a contingency that would make the transfers into these funds from the Foundation Aid Stabilization Fund effective only upon approval of a constitutional amendment by the Legislative Assembly in 2015 and by the voters in June 2016 to allow for additional uses of the Foundation Aid Stabilization Fund. The bill draft provides for a transfer of $250 million into the School Construction Assistance Loan Fund and a transfer of $200 million into the Public Employee Retirement Stabilization Fund.

Actuarial Cost and Technical Analysis:

The proposed legislation would affect the cost of the PERS Hybrid Plan in a variety of ways. There are a number of variables that will impact the cost. Results on various assumptions are attached in Exhibits A, B & C. Please note that the estimates in these charts are extremely sensitive to the actuarial assumptions used. A brief summary follows.

- If a single lump sum payment is made on January 1, 2016 into the PERS trust fund so that (in addition to ongoing contributions) the Hybrid Plan would be projected to pay all projected benefits due, the amount would be $92.9 million assuming an 8% rate of return and 40% of current Hybrid Plan members transfer to the DC Plan. However, as indicated in a recent letter from Callan Associates, an 8% return assumption may not be reasonable for a closed plan. If a lower return assumption is used, this amount increases substantially. At a 7% rate of return, the lump sum amount is $320.1 million; at a 6% rate of return, the lump sum amount is $600.6 million; at a 5% rate of return, the lump sum is $953.0 million; at a 4% rate of return, the lump sum is $1.404 billion (see Exhibit B). The $92.9 million calculation assumes that this amount is contributed to the trust on January 1, 2016. If the contribution is delayed, the required amount would increase. Based upon the funding mechanism proposed, our understanding is that the most likely date a payment would occur would be July 1, 2017, in which case a lump sum amount of $104.1 million would be needed, assuming 40% of current DB members transfer and an 8% rate of return assumption. This amount would be

$354.1 million assuming a 7% rate of return; at a 6% rate of return, the lump sum amount is $655.1 million; at a 5% rate of return, the lump sum amount is $1.025 billion; at 4% it is $1.489 billion. If the number of people transferring from the Hybrid Plan to the DC Plan were to increase, the required lump sum payment needed would increase, and if the number of transfers were to decrease, the required amount needed would decrease.

- If the Statutory Contribution Rate were adjusted so that the Hybrid Plan could pay all projected benefits due, the increase would be higher under the proposed legislation than it would under the current plan. The recommended contribution rate would increase by 3.39% (from 14.12% to 17.51%) effective January 1, 2016 for the Main System (State only), assuming an 8% rate of return assumption and 40% of current Hybrid Plan participants transfer to the DC Plan. At a 7% rate of return, the increase to the recommended contribution rate is 10.93%; at a 6% rate of return, the recommended contribution rate is 19.11%; at a 5% rate of return, the increase to the recommended contribution rate is 28.12%; at a 4% rate of return, the increase to the statutory contribution rate is 38.2%. These calculations assume that the required increase in contributions takes place on January 1, 2016. If the date of increase were delayed, the required contribution increase would also go up. If the number of people transferring from the Hybrid Plan to the DC Plan were to increase, the required contribution increase would go up, and if the number of transfers were to decrease, the required contribution increase would go down. These estimates are for the life of the Hybrid Plan and involve a funding period of 50 years or more. If a 20-year, 30-year, or 40-year timeframe for funding is used, the required contribution increases would all be substantially higher. For example, to fund the Hybrid Plan over 40 years would require a contribution increase of 19.08% as of January 1, 2018 at an 8% rate of return.

- If the Statutory Contribution Rate is not adjusted or a transfer of assets into the fund is not made, the Main System's assets that are allocated to State employees are projected to be exhausted in 2049 assuming an 8% rate of return assumption and 40% transfer of members transfer from the Hybrid Plan to the DC Plan. At that point in time the remaining unfunded liability is projected to be $1.190 billion. At a 7% return assumption, the projected exhaustion date is 2041 with an unfunded liability of $1.770 billion; at a 6% return assumption, the projected exhaustion date is 2037 with an unfunded liability of $2.139 billion; at a 5% return assumption, the exhaustion date is 2034 with an unfunded liability of $2.515 billion; at a 4% return assumption, the exhaustion date is 2033 with an unfunded liability of $2.866 billion.

- As Hybrid Plan assets are transferred to the DC Plan and liquidity requirements increase in order to make benefit payments, the Hybrid Plan investment allocation may need to be revisited. If assets are invested so that the expected return on investments is lower than 8%, the contribution rate needed to achieve full funding or pay ongoing benefits will be higher. (See attached letter from Callan Associates).

- The proposed DC Plan does not provide the same level of spouse or disability benefits as the current Hybrid Plan. Also, the proposed DC Plan does not contain the Portability

Enhancement Provision (PEP) that provides an incentive for supplemental retirement savings under the Hybrid Plan.

- If the proposed legislation were adopted, then there will be further challenges to the current approach of providing Ad Hoc adjustments to retiree benefits since contributions to the Hybrid Plan will be reduced.

- Bill 176 shifts the investment risk from the employer to the individual members. Investment education will be needed to help the member with this added responsibility.

- Based upon the experience of the existing DC Plan, the proposed DC Plan is not sufficient to provide the same level of retirement security that current Hybrid Plan members receive. An increase to the DC Plan contribution to provide comparable retirement security would result in a large increase in the cost of the proposed legislation. (See attached study from Segal dated July 17, 2013).

The current bill draft would only close PERS to future State employees. Since roughly 50% of the active population is employed by political subdivisions, the Hybrid Plan could be modeled as if it were an open plan. That is, if the bill were to pass, the Plan would continue to add new entrants, but at a slower rate than under the current Plan. This would create an inequity for the political subdivision employers and members of the Hybrid Plan resulting in State costs being shifted to them.

Since the Plan is funded with contributions that are a percent of active payroll, the political subdivisions, by continuing to add active members, would assume a larger and larger share of the burden of paying off the Unfunded Actuarial Accrued Liability (UAAL). Although the bill does not prevent the political subdivisions from adding new entrants, there is no reason to assume they would continue to do so if it meant they would be responsible for more than their fair share of the cost of the Plan. These subdivisions could choose to stop adding new entrants and could withdraw from PERS at any time, in which case they would only be responsible for paying off the UAAL for their own participants.

The only practical way the Plan could continue as an open plan would be if the Main System were divided so that State employees made up a single cost group. This would mean the State would be responsible for paying off the UAAL associated with State employees and would become a closed plan. We have assumed that if the bill passed, State employees would make up a separate cost group as of January 1, 2016. By doing this we can accurately reflect the State's funding obligation, which would then be independent from that of the political subdivisions. However, if PERS does not establish and maintain separate cost groups for State employee members and political subdivision members, in response to enactment of this proposed legislation, it is likely political subdivision employers will reconsider continuing participation in the Hybrid Plan. Should political subdivision employers choose to stop adding new entrants and withdraw from the Hybrid Plan, the impact of this proposed legislation on the Hybrid Plan's funded status, as detailed herein, would be further exaggerated.

Impact on the Systems' Assets

If the Main System were closed to new State employees, the State employees' segment of the assets would be exhausted if the current statutory contribution rate were left unchanged. Closing the Hybrid Plan to new members and allowing current participants to opt into the DC Plan reduces the Hybrid Plan's future liabilities, but it also removes an important funding source. These do not counterbalance each other. Plan assets of and contributions to the Hybrid Plan are reduced as soon as members and their associated contributions are diverted to the DC Plan, but benefit payments for the Hybrid Plan participants continue to be due for many years. It will become increasingly difficult to make up the funding shortfall as the payroll of active members decreases.

While the total value of all benefits to be earned in the future is smaller under Bill 176, there are two important points to note. First, the Hybrid Plan shortfall is nearly as big as it is under the current Hybrid Plan, but the Hybrid Plan payroll is declining under Bill 176, so it may be more difficult to make up the shortfall. Secondly, since current members who opt to transfer to the DC Plan will take the greater of the actuarial present value of the accumulated benefit obligation or the accumulated employer and employee contributions, the net liability shortfall will grow.

Impact on Contribution Requirements

One way to measure the effect of the bill on the cost of the Hybrid Plan is to calculate the contribution rate to fully fund the Plan so that assets will be sufficient to pay all benefits. Note that this rate is different than the actual contribution rate, which is set in statute and may not reflect the true cost of the Plan. The proposed bill would increase the immediate cost of the plan, primarily due to the fact that the Unfunded Actuarial Accrued Liability (UAAL) could no longer be amortized over the same future payroll that would be expected under the current open group.

The following table shows the total contribution requirements as of July 1, 2014. The "Current Plan" uses amortization of the UAAL over 20 years as a level percent of payroll, which is assumed to increase 4.5% per annum. The "Closed Plan" amortizes the UAAL as a percent of projected payroll of the group that is closed as of December 31, 2015.

Estimated Total* Contribution Requirements to Achieve 100% Funding (MVA) in 20 Years

	Current Plan	
	Amount (000's)	Percentage of Payroll
1. Main System (State Only) Current System with costs shared by Political Subdivisions	$193,400	16.74%
2. Closed Plan (State Only) With no DB to DC transfers	$330,800	22.56%
3. Closed Plan (State Only) With 40% of DB participants transferring to DC	$376,400	28.86%
4. Closed Plan (State Only) With 80% of DB participants transferring to DC	$422,100	49.69%

** Employer plus member contributions as of January 1, 2016*

Note that the costs of the defined benefit plans are projected to increase in the future for the following reasons:

- Closing the Hybrid Plan will ultimately require changes in asset allocation that will likely produce lower investment returns. This will increase the UAAL and the actuarial contribution requirement. Note that in the summary we have not taken any asset reallocation into account in this analysis and have instead used an 8% long-term expected rate of return for the projection period. Results on alternative investment allocation bases are shown in the attached Exhibits A, B and C. (Also see the attached letter from Callan Associates).

- For the Main System, the statutory contribution rate is currently less than the actuarially determined contribution rate, which leads to increased actuarial costs unless offset by experience gains.

Impact on Reporting (GASB 67 & 68)

The Governmental Accounting Standards Board Statements Nos. 67 & 68 set up new disclosure requirements for public pension plans. Since this bill sets forth no funding method for the Hybrid Plan, it will increase the unfunded liabilities on the financial statements, which could influence the overall financial ratings of the State and its employers. The various rating agencies have recently made public statements equating management of pension liabilities to management of debt. If the State does not conservatively manage either, the State's bond rating may suffer, causing additional unknown interest costs.

The bill will first affect the June 30, 2015 financial statements and actuarial report. Over the long term, the unfunded liability will likely increase and so will the actuarially required contributions. The fund's assets are projected to be exhausted in 2049. In addition, the unfunded liabilities reported on the financial statements will likely grow since, under GASB 67 and 68, the weak funded status will require that a lower interest rate be used for measuring the unfunded liability. This financial information could also encourage more of the existing members to elect to leave the Hybrid Plan, causing more transfers to the DC Plan and further accelerating the projected exhaustion date.

Technical Comments:

General

The bill essentially closes the Hybrid Plan to new entrants employed by the State, which means the bill would have a major impact in the following areas (described in more detail below):

- The proposed changes would have a significant impact on the funding status of the defined benefits plan; and
- Similarly situated employees would have different levels and forms of retirement benefits; and
- The role of the affected Systems in administering retirement benefits for State employees would shift dramatically over time.

Benefits Policy Issues

- Proposed Funding Method

  Funding the shortfall: Based upon the proposed funding method discussed in the memo from Legislative Council, the Hybrid Plan would be on a path to insolvency before a funding plan is approved. Specifically, it appears the effect of this bill is to close the Plan to new participants by January 1, 2016, which will put the fund on a course to exhaustion. To offset this funding shortfall, monies could come from the Foundation Aid Stabilization Fund, but only if a constitutional amendment is adopted by the voters and if the money is transferred by a future legislative session (2017 or later). The timeline proposed would create an unfunded liability before a funding mechanism is approved or implemented. Assuming 40% of current members transfer from the Hybrid Plan to the DC Plan, the Hybrid Plan would be on a path to insolvency by 2049 (assuming an 8% rate of return) and facing a funding deficit of $1.19 billion that would have to be paid on a pay-as-you-go basis from the State's general fund, unless a retirement funding plan is adopted and implemented by a future legislature. At a 7%

return assumption, the insolvency date would be 2041, and at a 6% return assumption, the insolvency date would be 2037.

Integrity of the Trust: Based upon the funding plan discussed in the memo from Legislative Council, no specific plan is established to guarantee the necessary funding to the retirement fund as established under North Dakota State law. Holding members' funds in a retirement trust is important since the trust is held for the exclusive benefit of the members and managed according to the prudent person rule. The plan outlined in the Legislative Council memo is that retirement monies would potentially be held in a Retirement Stabilization account that is not part of the retirement trust. Keeping retirement money in the retirement trust instead of a non-retirement trust as proposed in this bill is important for several reasons: 1) it is set aside for retirement and is protected from claims by creditors of the employer; 2) the money is managed by trustees whose sole responsibility is the benefit programs they administer; 3) the funds cannot be diverted for other uses; and 4) the money is set aside for the members' retirement instead of having to rely on the goodwill of future Legislatures to transfer the necessary funds.

By contrast, having retirement money in a non-retirement account means the retirement plan members do not have any ownership in the account or its assets (which could be diverted for uses other than funding PERS) nor does the non-retirement account specifically address funding problems created due to closing the Hybrid Plan. Also, a non-retirement account that is not set up for the exclusive benefit of the members means that it could be managed by non-retirement trustees who may have broader ranging responsibilities that may at times be in conflict with those of the retirement plan. While these wider ranging set of interests could be well intentioned, they may not be consistent with the needs of the retirement plan. The wider set of interests could include such things as Economically Targeted Investing and social investing that could be a benefit to the State or certain segments of the State but not to the retirement plan. This also is not consistent with general methods of managing retirement assets. Holding money in a separate account would not pass the ERISA test in the private sector since funding of the trust is not clear (ERISA does not apply to governmental plans). Consequently, North Dakota could be doing something that would not be allowed in the private sector.

In the governmental sector, the closest example of holding funds in a non-retirement fund is the 457 plan assets. Prior to the mid-1990's these funds were a general asset of the employer. In the mid-1990's several local governments faced bankruptcy and these funds were at risk to the creditors of the employer. This so shocked the public that Congress passed a federal law that required these funds to be held in a trust for the exclusive benefit of the members.

These situations point out the importance of retirement funds being held in a trust, the sole purpose of which is to meet the needs of its members. It also points out that holding money in a separate fund that may be required to meet a broader range of needs raises many concerns. This would provide less security to members since members would now be relying on the good intentions of future legislatures to ensure Plan benefit payments.

- <u>Adequacy of Retirement Benefits</u>

  - *Replacement Ratio*: In comparison to members in the current Hybrid Plan, the replacement ratios of retirement benefits to pre-retirement income for new members in the DC Plan are expected to decrease from that which is currently provided for several reasons, including the following.

    - In practice, individually managed accounts can expect lower investment returns than professionally managed defined benefit funds.

    - DC Plan accounts suffer from "leakage" as funds are used for purposes other than retirement.

    - Members must assume longevity risk on top of investment risk, or face a high cost of annuitization at market annuity rates.

    In a letter dated July 17, 2013 (attached) we provided an analysis of how benefits under the Hybrid Plan compare to benefits under the DC Plan. It showed that the contribution rate for the DC Plan would need to be dramatically increased in order to provide a benefit that is comparable to the current Hybrid Plan. Specifically the analysis shows the following for individuals who are presently in the DC Plan established in the late 1990's:

    1. DC Plan participants are projected to have a retirement benefit that is less then what they would have had if they stayed in the Hybrid Plan in almost all cases.

    2. DC Plan contributions will need to increase to 20% or more to provide a similar benefit to the current Hybrid Plan (e.g., under the Hybrid Plan a 25-year employee would receive 50% of their final average salary).

    3. For those individuals that are age 55 and above, the effect of the market downturns on their portfolios makes it extremely difficult for them to recover even if contributions are increased dramatically. The market downturn of 2008 highlights one of the risks faced by DC Plan members.

    4. The benefit provided in the existing DC Plan is not adequate in providing a comparable benefit to the Hybrid Plan at the existing contribution level

    In a survey of DC Plan members conducted last year (31% responding), 65% of the responding members feel they made a mistake by transferring to the DC Plan, 69% would not recommend the DC Plan to others, 80% would switch back to the Hybrid Plan if given the opportunity, and nearly 70% think they are on the wrong track for retirement. The most likely reason for the high level of dissatisfaction is that most people do not feel they have enough savings to retire.

    The PERS Board has been concerned with the pension adequacy of the DC Plan for many years. Consequently, the DC Plan has been a part of the recovery plan PERS proposed in

2011. At that time, PERS proposed increasing the contributions to this Plan to 16.12% of covered payroll with a 2% increase in 2012, 2% in 2013, 2% in 2014 and 2% in 2015. To date, the legislature has approved the 2012, 2013 and 2014 increases. As a result of the PERS Board's continued concern, they have submitted a bill to the Legislative Employee Benefits Committee for the last 2% increase to be considered by the upcoming legislature. The Board will be studying if future increases are needed.

- *Retirement Savings:* The nature of the DC Plan with lump sum benefit payments may decrease the amount that will be available for retirement to the extent it is used for current consumption. Employee Benefit Research Institute (EBRI) statistics indicate that because of this "leakage" effect, less than 100% of employer contributions will actually be used to provide retirement benefits. Based upon the EBRI study entitled "Reported Uses for Any Portion of Lump-sum Distributions", the average amount of distributed funds retained in retirement vehicles (tax-qualified financial savings) is 41.5%. Seventeen percent is saved, and the remainder (41.5%) is used for debt, education or consumption. Forty-six percent of these individuals rolled over at least some of the money into another retirement plan and 27% put some of the money into other savings investments. Because of this "leakage" effect, less than 100% of the employer contributions will actually be used to provide retirement benefits. Nationally, 58.5% of any lump sum distribution is not used for retirement purposes. The current Hybrid Plan has minimal leakage of employer contributions.

- *Personal savings:* Participation in a defined contribution plan may encourage members to save for retirement because of the participant-directed investment feature and the awareness that it is important to save for their own early retirement or post-employment inflation protection. However, the State's DC Plan does not provide any separate monetary incentive or opportunity to increase personal savings. The existing PERS main retirement plan added the PEP feature in 1999. One aspect of this provision is to create an incentive for members to engage in supplemental retirement savings. Specifically, this feature provides that if a member participates in the State's deferred compensation plan, they will vest in the employer contribution in the Hybrid Plan. This provision has helped to encourage participation in the supplemental savings plan and has been successful at enhancing the overall retirement preparedness for those participants. The proposed DC Plan would not have a similar defined benefit incentive to encourage participation.

- *Other Plans:* Other states with defined benefit plans have converted to defined contribution plans for new hires in recent years. Examples include Alaska, Michigan, and Oklahoma (effective for new hires after November 1, 2015). A notable exception is West Virginia, which replaced its teachers' DC plan with a DB plan in 2005. Some states have moved from DB plans to DB/DC combinations (Oregon, Utah, and Rhode Island) or hybrid arrangements such as a cash balance plan (Nebraska, Kentucky, and Kansas). Utah offers new employees a choice between a pure DC plan and a hybrid DB plan with a capped employer contribution. In many cases, such as Alaska and Michigan, supplemental contributions have been needed to help with the funding of the closed DB plans.

- Benefits Equity and Group Integrity

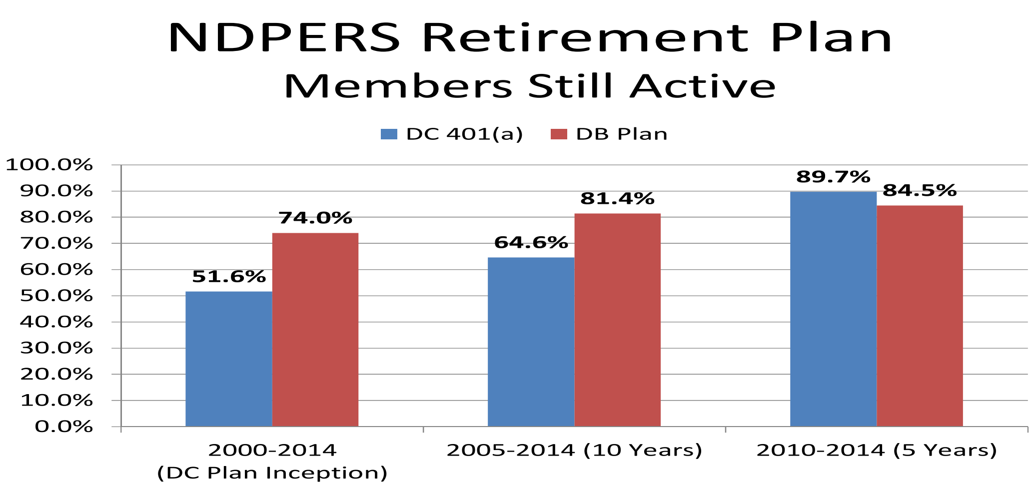
  Under the bill, virtually all State employees hired after December 31, 2015 would accumulate employer-provided retirement benefits only under the DC Plan. There is an equity issue in having two types of retirement plans in the workplace with newer employees in the new DC Plan and older employees in the current Hybrid Plan. If the contribution levels for the DC Plan remain at 14.12% of pay, there will be a clear inequity between the two groups.

- Competitiveness and Retention

  The DC Plan design increases the ability of shorter-term employees to earn and retain a valuable retirement benefit. The Hybrid Plan's Portability Enhancement Provision (PEP) also offers similar benefits, which can be a valuable tool for attracting such employees. The proposed DC Plan, however, may be less competitive for career employee positions compared to other public employee retirement plans. The proposed changes could motivate job mobility and increase turnover. This may or may not be desirable depending on the workforce issues facing the State.

  The bill will be following the trend among smaller private sector employers to use defined contribution plans instead of defined benefit arrangements as a primary vehicle for retirement benefits. However, it does not match the designs of most public sector employers that have continued to maintain a combination plan structure - a core defined benefit plan with a supplemental set of defined contribution and/or profit sharing arrangements.

  Based upon data collected by the System staff, the Hybrid Plan has more continuing actives since inception than the DC Plan as shown in the following:



Since 2000, more members of the Hybrid Plan have remained than those in the DC Plan. However, in the short term, the DC Plan has a slightly higher rate. This could be due to the existing vesting criteria which requires employees to stay in the plan a certain number of years before vesting 100% in the employers contributions. This bill would allow more DC Plan participants to leave earlier and be fully vested in their contributions and so the results above could change.

- Purchasing Power Retention

A defined contribution plan does not provide guaranteed purchasing power retention after benefits are distributed. The ability to maintain purchasing power will depend solely on the investment performance of the distributed assets. It is not possible under current federal tax laws to directly provide post-retirement increases for defined contribution plan retirees.

- Preservation of Benefits

A defined contribution plan can work well to preserve the value of benefits for former members but actual preservation of such values will depend on the investment performance on the amounts distributed. To the extent benefits are not invested adequately or not saved for retirement purposes, the value of the retirement benefits is diminished. In addition, participants who receive lump sum benefits such as those that are paid from a defined contribution plan face the following risks not present in receiving an annuity from a defined benefit plan:

- *Longevity risk:* Retirees may draw down benefits too quickly and outlive their assets. Conversely, retirees may draw down their benefits too slowly, unnecessarily reduce their consumption, and leave more wealth than intended when they die.

- *Investment risk:* Assets in which retirement savings are invested may decline in value. Safer investments that are less likely to decline in value may earn lower returns.

- Portability

The bill generally provides a high degree of portability of retirement benefits for new State employees who participate in the DC Plan, since their entire benefit is available for distribution or rollover after termination of employment. Note that under the PEP provisions, the existing Hybrid Plan also offers a significant level of portability.

- Ancillary Benefits

- Pre-retirement death benefits and disability benefits provided under a defined contribution plan would generally be less than similar benefits provided under a defined benefit plan structure because defined contribution plan benefits depend on the total amount of contributions made and investment performance of assets, while defined benefit plan benefits are not contingent upon such factors. Specifically:

1. The Hybrid Plan provides for a disability retirement benefit of 25% of final average salary calculated at the date of disability. A member is eligible for this after six months of participation in the system. The proposed DC Plan would offer no other disability benefits other than the account balance at the date of disability, which in most cases would be much less that the current Hybrid Plan disability benefit. Many employers provide disability insurance benefits to employees, which offsets the need for this in the retirement plan. It is our understanding the State does not currently provide employer-paid disability insurance to its employees, meaning that disability benefits under the bill would be less than State employees currently receive.

2. North Dakota Century Code Section 54-52-17(6)(b) provides benefits for surviving spouses under the Hybrid Plan. Essentially the spouse has three choices: 1) a lump sum payment of the member contributions with interest, 2) lifetime payment of monthly benefit equally to fifty percent of the deceased member's accrued single life benefit, or 3) if the member at death was eligible for a normal retirement benefit the spouse can select a benefit equal to the member's 100% joint and survivor annuity benefit. In the proposed DC Plan, the spouse would only be eligible to receive a lump payment of the account balance. Generally, the proposed DC Plan benefit would be significantly less than the spouse benefits in the Hybrid Plan. Many employers do have employer-paid life plans that offset the need for this benefit in the retirement plan. In North Dakota, it is our understanding that the State only provides $1,300 in life coverage for retirees and $3,500 for active employees with supplemental life insurance coverage available to active employees at additional costs, up to a maximum benefit of $200,000. In the DC Plan, a death benefit could be added or the State could provide expanded life insurance coverage to provide for the surviving spouse. If this is not provided, the bill would result in lower death benefits for State employees than are provided by the current Hybrid Plan.

- The PERS Hybrid Plan has from time to time provided for retiree increases with ad hoc adjustments. This has occurred as a result of favorable Plan experience and when the Plan's funding situation has allowed. At some future date, it is possible that the Hybrid Plan may reach a funded level that would allow it to again provide ad hoc adjustment to retirees. Under the proposed legislation, contributions to the current Hybrid Plan will decrease as the active population decreases, and the assets will decrease as the liability for members is paid off over time. Since the contributions under the closed plan will be used for paying off the unfunded liability, it is unlikely that excess contributions will be available to fund ad hoc increases to current retirees. This could result in retirees of the political subdivision portion of the Plan getting increases funded from the Plan and those in the State portion of the Plan not getting similar adjustments (unless the legislature sets another funding mechanism).

  In addition, since DC Plan balances are individual accounts, the proposed DC Plan does not provide for sharing of favorable Plan experience among members, nor does it specifically provide for ad hoc adjustments to retirees. However, those individuals in the proposed DC Plan that realize favorable investment experience would benefit from what would generally be comparable to an ad hoc adjustment. If the State has a wish to someday provide retiree adjustments, a new process would need to be identified.

- Social Security: No impact.

- Retiree Health Insurance Credit Plan: Benefits under the current Retiree Health Insurance Credit Plan (RHIC) are coordinated with the Hybrid Plan. Members who are eligible for benefits under the Hybrid Plan are also eligible for the health credit. In order for a member of the DC Plan to be eligible for this benefit, they must elect to receive a periodic payment upon retirement. Members who elect a lump sum payment do not receive the RHIC benefit.

Funding Policy Issues

➢ Actuarial Impacts

As previously noted, the bill will have an actuarial impact on the Hybrid Plan.

- The bill will have an effect on the actuarially recommended contribution (based upon a 20-year funding period), increasing it to 28.86% on January 1, 2016, assuming an 8% rate of return and 40% of Hybrid Plan members transfer into the DC Plan.

- The bill will not provide for a change in the statutory contribution rate, which could cause a decreased funded status and increased unfunded liability as will be shown in the June 30, 2015 actuarial valuation report.

- Projected contributions will be lower than they otherwise would be beginning January 1, 2016.

- While the effect on benefit payments will not be immediate, transfers from the Hybrid Plan to the DC Plan will remove assets from the Hybrid Plan. If a significant portion of members elect to transfer, the Plan may experience cash flow issues since the amount of annual benefit payments will be a higher percentage of total assets. This could force the fund to sell investments in order to have the funds to make benefit payments.

➢ Investment Impacts

- Altering the existing investment process, as outlined in the Legislative Council memo, by depositing the funds into the Retirement Stabilization fund (instead of directly into PERS fund) would leave funds outside the existing retirement investment management process. If the same level of diversification and risk reduction were to be accomplished, having the funds in the Retirement Stabilization Fund could increase investment costs which are the single highest cost of program administration. This is something both the PERS

Board and TFFR Board recognized in the late 1980's when the two boards came to the Legislature to reorganize the State retirement investment process. The proposal at that time was to establish a mechanism to allow comingling of retirement assets for investment purposes under the State Investment Board. The proposed method was more cost effective because manager savings were achieved by investing larger sums. However, if money is to be held in a non-retirement fund with the same level of diversification, this co-mingling may not occur since the other fund would not be a part of the current system. Consequently, investment costs could rise.

- Depending on the performance of the capital markets and the investment choices made by members, new employees participating in the DC Plan may experience greater, or, more likely, lesser benefits than those provided under the current Hybrid Plan. The risk of loss or gain is borne by the individual member and there is no risk sharing among DC Plan participants.

- *Cash Flow*: As indicated above, a significant drop in assets associated with a large number of transfers from the Hybrid Plan to the DC Plan could cause cash flow issues as ongoing benefit payments would be a larger percentage of plan assets. This could force the fund to sell investments in order to have available funds to make benefit payments.

- *Asset Allocation:* The bill may create new investment asset allocation issues for the Hybrid Plan as the amount of new contributions to the Plan decreases relative to the amount of benefit payments from the Plan (see Callan letter). Specifically, the asset allocation for the PERS State system would likely need to change if 40% or 80% of the members transferred out of the Plan. This would likely effect the assumed rate of return in order for the Plan to maintain the necessary liquidily to pay benefits. This will need to be studied in more detail.

<u>Administration Issues</u>

➢ <u>Implementation Issues</u>

- The following comments on implementation were provided by PERS staff:

Legislation requirement (New Employees)	Effect/Comment
General – consideration should be given to stating in statute that the state plan and political subdivision plan are separate after the date of implementation of this bill	This will clearly state legislative intent that it is not the desire of the state to shift costs of the closing of this plan to the political subdivisions.

Section 5 An eligible state employee hired for the first time after December 31, 2015, would be required to enroll in the defined contribution plan under Chapter 54-52.6, rather than the defined benefit plan.	All new employees join the DC plan starting Jan 2016. The direction on how to administer this provision is clear

	Legislation requirement (Existing Employees)	**Effect/Comment**
1	Section 4 includes an election for all eligible employees, who are first employed before January 1, 2016, and who are members of PERS on June 30, 2016, to terminate membership under the defined benefit retirement plan and transfer to the defined contribution retirement plan	Those state employees first employed before Jan 2016 and who are members on June 30 get to transfer. Our understanding of this section is only active state employees of the system who were employed before Jan 2016 and are still active state employees of the system on June 30 will get the opportunity to transfer. We also believe this section means that they must also be an eligible state employee on the date of transfer although this is not as clear. For example: 1. Someone meets the requirement on June 30 but terminates employment after transfer – they would stay in the DC plan. 2. Someone meets the requirements on June 30, makes an election to transfer but terminates employment before the transfer – their transfer would be negated and they would remain a member of the Hybrid/ DB plan. 3. State employee employed before Jan 2016 transfers employment prior to June 30, 2016 to political sub who participates in PERS – not eligible to transfer since not a state employee on June 30, 2016 4. State employee employed before Jan 2016, but transfers employment prior to Jan 2016 to political sub who participates in PERS – not eligible to transfer since not a state employee on June 30, 2016 5. Someone fist employed before Jan 2016 but not on payroll on June 30 would not get the opportunity to transfer. 6. Clarification of the above in statute would be helpful

<table>
<tr><td>2</td><td>Section 5: The election period would begin July 1, 2016, and would end December 30, 2016 for eligible employees who are first employed and entered upon the payroll of that person’s employer. .</td><td>This section lines 24 through 30 seems to indicate that eligible employees hired after 1/1/2016 have an election period from July 1, 2016 – December 30, 2016However other parts of the bill state that all newly hired employees after 1/1/2016 can only enroll in the Defined Contribution plan. This needs to be clarified.</td></tr>
<tr><td>3</td><td>Section 7 states the transfer amount shall be:

1. The actuarial present value of the individual's accumulated benefit obligation under the public employees retirement system based on the assumption that the individual will retire under the earliest applicable normal retirement age, plus interest from January 1, 2001, to the date of transfer, at the rate of one-half of one percent less than the actuarial interest assumption at the time of the election; or

2. The actual employer contribution made, less vested employer contributions made pursuant to section 54-52-11.1, plus compound interest at the rate of one-half of one

percent less than the actuarial interest assumption at the time of the election plus the employee account balance</td><td>This is clear as to the transfer amount. However:

1. The date of “January 1, 2001” needs to be removed.

2. Determining the contribution plus interest amount method is a very time intensive effort since the information needed to determine compounded interest on the employer contributions is not stored in our business system. Therefore, a manual calculation needs to be made for each member. If it was ½ hour per member, then if 40% of the members (4,000) elected to transfer it would take us 2,000 hours or 12 months of effort. If 80% elected to switch (8,000 members) it would take us 4,000 hours or about 24 Months of efforts. In 1991 this was done for about 600 members and we hired three temporary staff to assist; however, this time it would be for many times that number. This could require us to hire 2-3 temp staff for about 6-8 months or 4-6 staff for 3-4 months which would require an appropriation to be added to the bill.

3. Pursuant to the bill we would only be determining the amounts in #2 above after the election period. Therefore we would not be able to transfer funds to the DC plan until this analysis is competed which would be in the last half of 2017 or earlier depending on the staffing. Without additional staffing it is uncertain when this could be completed but it would certainly be more than a 12-18 months. This means that people who made the election to transfer would need to wait a long period of time for it to occur and if they may no longer be employed on the date of the transfer so they would no longer be eligible (see row 1 above). We expect this would become an issue that would frustrate many members. Alternatively, a different method could be developed to calculate the interest on the employer contributions that would be more abbreviated thereby reducing the cost of staff and time. Also instead of the transfer occurring all at one time it could be staggered</td></tr>
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		over time but then who would go first. Also since there would be a long delay and if the investment environment was positive it could expose the plan/state to lawsuits for lost earnings. Further guidance and funding is needed for this section.
4	**Section 8** of the bill draft amends Section 54-52.6-10 of the **defined contribution plan** and provides a participating member is 100 percent vested in the employer contributions made on the member's behalf upon completion of one year of service.	Not sure if this would apply to only those members joining the plan after December 2015 or to all members.
5	**Section 9** of the bill draft provides that for the period beginning January 1, 2016, and ending June 30, 2017, upon the request of an individual who is eligible for termination of membership in the public employees retirement system under chapter 54-52 as provided for in Subsection 1 of Section 54-52.6-02, the public employees retirement system shall estimate the individual's accumulated balance transfer amount by calculating the actuarial present value of the individual's accumulated benefit obligation under the public employee's retirement system based on the assumption that the individual will retire under the earliest applicable normal retirement age.	1. The period from January 1, 2016 to June 30, 2017 exceeds the election period, which is from July 1, 2016, and ends December 30, 2016. PERS would not be able to provide information earlier than the election period or later unless it was information that was not current. 2. It is clear that PERS would only provide members the actuarial value of the transfer amount. However, members would get the higher of the actuarial value or the contributions plus interest as noted above. Pursuant to this section we would not be providing members what they would actually be getting which will be frustrating to many. Based upon the two previous times this was offered in 1999 61% of the eligible members had a transfer amount greater than the actuarial value and in 2001 66% did. Consequently, many members will need to consider an election without knowing the exact value of what they could get. We expect many members will be dissatisfied without having a full disclosure and could subsequently argue they would have made a different decision if they had been fully informed.

- <u>Administrative Costs</u>

The bill will have an impact on the administrative resources needed for both the defined benefit plans and the DC Plan because it would add a relatively large number of new members to the DC Plan. Administrative costs may need to be reallocated from the defined benefits plans to the Defined Contribution Plan over time, as membership numbers shift to the DC Plan. Initially, however, the bill will require maintaining the administrative resources for the defined benefit plans, while increasing the administrative resources available to the DC Plan. Funds will need to be provided to pay for implementing the transfer provision, if not significant delays in implementation will occur.

Furthermore, PERS would be required to provide detailed calculations to Hybrid Plan members in order for them to transfer to the DC Plan. As noted earlier, this would involve significant time and expense to prepare for transferring members.

- Needed Authority

The bill appears to require additional administrative and governance authority as noted above for the PERS Board to implement the changes made by the bill.

- Integration

No impact.

- Employee Communications

1. Not disclosing to members full information for them to consider the transfer provision can be a significant concern to members. As proposed, members will only get the elegible transfer amount based upon the actuarial present value of the benefit. They will not get information on the account balance. This means members will need to make a decision without the benefit of full disclosure on the information. This will undoubtedly cause frustration with the membership during the election period. Afterward, members could assert that they would have or would not have done the transfer if they had received the full amount of disclosure. On an ongoing basis, this could be an issue.

2. The nature of defined contribution plans allowing participant-directed investments will require additional employee education effort regarding retirement and investment planning. The need for this effort is supported by information found in a recent retirement portability study conducted by the federal Office of Management and Budget. A survey of employees indicated an overall low level of understanding of the how to invest moneys for retirement. The survey indicated a low level of understanding regarding investment categories and investment risk. Because the DC Plan will be the primary retirement vehicle for its members, it will be critical to provide these education services.

3. Consideration should be given to participant education, including requiring or allowing members to attend financial planning seminars and meeting with financial advisors in the work place and during working hours. Increasingly, sponsors of defined contribution plans are making available investment advisory services to assist

members to invest their retirement assets prudently. There are a variety of methods for providing these education and advisory services that should be examined, including group meetings, individual counseling and technology based approaches. With a DC Plan, individual members are responsible for monitoring their own investment performance and making changes as appropriate. Their success or failure is a direct result of how they fulfill this responsibility.

- <u>Miscellaneous</u>

  - Consideration should be given to examining the fiduciary issues surrounding defined contribution plans, including the nature of the risks associated with participant-directed investments, provision of employee investment information and education, self-directed brokerage windows, financial and retirement planning and investment advisory services.

  - To date, the Legislature has approved three years of the 4-year recovery plan for PERS. Contribution increases under this recovery plan are shared between the employer and employee with one-half being paid by each party. When proposed, it was projected that as employers and employees contributed to this effort it would stop the downward trend in the funded status of the Hybrid Plan and put it on a course to 100% funding. Both employees and employers have paid their share and at this point the total increase has been 3% of salary. If this bill (LC 176) passes, it would again put the Hybrid Plan on track to insolvency unless the constitutional amendment is passed and future legislatures immediately start depositing money in the trust fund to reverse that trend. Clearly, this bill will change the perception of the PERS Hybrid Plan with employees. This could cause members to reconsider their commitment of contributing to the Plan. While it is hard to determine the implications of such reconsideration, one result could be a lawsuit by aggrieved members. As we have previously noted, there is a risk that a court could find such contribution requirements a violation of the contract for existing employees possibly resulting in a loss of the employee contributions thereby increasing the employer requirements. While this is a remote risk, it needs to be recognized. We note that in the State of Michigan they have increased the contributions for members of their closed DB plan (they were one of the first states to close their DB plan and have new members go to a DC plan) and the state was challenged by employees in court. At this point, two lower courts have held that the employee contribution cannot be increased and the case is now pending before the State Supreme Court.

  - Long-Term Costs: Once the unfunded liability of the Hybrid Plan is paid off, the contribution level can be decreased to the normal cost which today would be 10.31% of payroll. If the DC Plan contribution level is set at the current rate of 14.12% or the 16.12% rate PERS is proposing, then after the unfunded liability is paid off, the long-term cost of the DC Plan is the difference between the two rates. Specifically, the long-term cost of the DC Plan could be anywhere from about 3.8% to about 5.8% higher, based on future payrolls. These are substantial cost differences on future payrolls for participating employers, if accurate. Currently, the State payroll is over $517 million. If 40% of the Hybrid Plan members transfer, each 1% change in the contribution rate represents $2.1 million annually.

The projections were made using generally accepted actuarial practices and are based on the July 1, 2014 actuarial valuation results, including the asset information, participant data and actuarial assumptions on which that valuation was based except for benefit payments in the first fourteen years of the projections, which were adjusted to better reflect plan experience. In addition, the total active member population for the Hybrid Plan and DC Plan has been assumed to remain constant in all future years. All transfers from the Hybrid Plan to the DC Plan were assumed to occur on January 1, 2017. Calculations were completed under the supervision of Tammy Dixon, FSA, MAAA, Enrolled Actuary.

Projections, by their nature, are not a guarantee of future results. The modeling projections are intended to serve as illustrations of future financial outcomes that are based on the information available to us at the time the modeling is undertaken and completed, and the agreed-upon assumptions and methodologies described herein. Emerging results may differ significantly if the actual experience proves to be different from these assumptions or if alternative methodologies are used. Actual experience may differ due to such variables as demographic experience, the economy, stock market performance and the regulatory environment.

Please call if you have any questions or comments.

Sincerely,

Brad Ramirez, FSA, FCA, MAAA, EA
Vice President and Consulting Actuary

Sincerely,

Melanie Walker, JD
Vice President

cz

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