NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

EMPLOYEE BENEFITS PROGRAMS COMMITTEE

Monday, October 26, 2009
Harvest Room, State Capitol
Bismarck, North Dakota

Representative Bette B. Grande, Chairman, called the meeting to order at 9:00 a.m.

Members present: Representatives Bette B. Grande, David Drovdal, Ralph Metcalf, Lisa Wolf; Senators Ray Holmberg, Ralph L. Kilzer, Carolyn Nelson

Members absent: Representative Francis J. Wald; Senator Karen K. Krebsbach

Others present: See Appendix A

Chairman Grande recognized committee counsel. Committee counsel said the August 6, 2009, committee minutes should be revised. He said the second full paragraph on page 2 which states "Mr. Cochrane said the State Investment Board was also impacted by the Bernard Madoff financial scandal. He said the State Investment Board has written down $40 million and recovered $23 million to date" should be revised to read "Mr. Cochrane said the State Investment Board was also impacted by the financial scandal. He said the State Investment Board has written down 40 percent of the WG Trading portion of the assets and recovered $23 million to date from Westridge."

It was moved by Senator Holmberg, seconded by Senator Nelson, and carried on a voice vote to approve the August 6, 2009, minutes as corrected.

At the request of Chairman Grande, committee counsel distributed a copy of the October 2009 *Your Vested Interest* newsletter published by the State Investment Board. A copy of the newsletter is on file in the Legislative Council office.

STATE INVESTMENT BOARD FISCAL YEAR 2009 UPDATE

Chairman Grande recognized Mr. Steve Cochrane, Executive Director/Investment Director, Retirement and Investment Office. A copy of Mr. Cochrane's PowerPoint presentation is attached as Appendix B. He said the State Investment Board was involved in a financial fraud this past year but it was not the Bernard Madoff situation. He said the Bernard Madoff financial scandal was targeted at individuals. He said the situation that affected the State Investment Board involved WG Trading Investors, L.P./Westridge Capital Management. He said this investment had been in place for 10 years and had always performed very consistently. He said there were no particular indications of wrongdoing and Callan Associates--the board's investment consultant--performed two due diligence reviews. He said $23 million, the portion of the assets with Westridge Capital Management, was recovered immediately. He said there was $136 million placed with WG Trading Investors, L.P., and the board has taken a 40 percent write-down on these assets totaling approximately $54 million. He said approximately 35 entities were invested with WG Trading Investors, L.P., of which 7 were limited partners. He said the State Investment Board was a limited partner and the fraud took place with investments held by noteholders rather than the limited partners. Thus, he said, the State Investment Board believes it should be treated as a separate class and is moving forward accordingly.

Mr. Cochrane said the State Investment Board has $4.2 billion under management, of which $2.9 billion is pension trust money. He said $1.1 billion is insurance trust funds, of which 95 percent is the Workforce Safety and Insurance fund. He said for fiscal year 2009, the Teachers' Fund for Retirement was down 27.33 percent and the Public Employees Retirement System fund was down 24.42 percent. If there is good news, he said, it is that on the pension side it appears that approximately 82 percent of the total loss is unrealized. For Workforce Safety and Insurance, he said, the unrealized loss is approximately 95 percent. He said the fiscal year return for the pension trust through October 21, 2009, is 14.59 percent.

VALUATION OF RETIREMENT, INSURANCE, AND RETIREMENT HEALTH INSURANCE PROGRAMS

Chairman Grande recognized Mr. Chris Conradi, Enrolled Actuary and Senior Consultant, Gabriel Roeder Smith & Company, Dallas, Texas, who presented the July 1, 2009, actuarial valuation of the Teachers' Fund for Retirement (Appendix C). A copy of the actuarial valuation is on file in the Legislative Council office. He said an actuarial valuation of the Teachers' Fund for Retirement is prepared every year as of July 1 using member data, financial data, benefit and contribution provisions, actuarial assumptions, and methods. He said the purposes of the actuarial valuation are to measure the actuarial liabilities of the fund; determine the adequacy of current statutory contributions; provide other information for reporting, such as Governmental Accounting Standards Board Statement No. 25 and financial reporting for the

Comprehensive Annual Financial Report; to explain changes in actuarial conditions; track changes over time; and to warn about possible future problems and issues. He noted the Legislative Assembly had enacted legislation in 2009 affecting the Teachers' Fund for Retirement. He said the Legislative Assembly established a supplemental retiree benefit payment consisting of a one-time supplemental payment to be paid in December 2009. He said this payment will be calculated using a formula of $20 times the years of service plus $15 times the years retired for the beneficiary. He said the payment is limited to the greater of 10 percent of the beneficiary's annual annuity or $750. He said members are eligible for the supplemental payment if they retired before January 1, 2009, and are still in payment on the distribution date. Also, he said, the Legislative Assembly increased the employer contribution rate from 8.25 percent to 8.75 percent effective July 1, 2010. He said the increase in the employer contribution rate is set to sunset back to 7.75 percent when the Teachers' Fund for Retirement is 90 percent funded.

Mr. Conradi said the number of active members increased by 146 from 9,561 to 9,707. He said the increase is due to implementation of full-day kindergarten. He said payroll for active members increased 5.3 percent from $417.7 million to $440 million. He said payroll has increased an average of 3.4 percent per year over the last 10 years. Average pay for active members increased 3.8 percent, he said, from $43,684 to $45,327. However, he said, the increase in average salary can be misleading because higher paid teachers who retire are replaced by new teachers, and there was a 5.8 percent average increase for continuing members. He said the average age for active members is 44.5 compared to 44.6 last year and to 44.0 ten years ago. The average years of service for active members is 14.3, he said, which compares to 14.4 last year and to 14.4 ten years ago. He said the number of annuitants increased by 149, from 6,317 to 6,466, an increase of 2.4 percent. Over the last 10 years, he said, the number of retirees has grown an average of 3.5 percent per year. He said the average annual retiree benefit is $18,162, and there are 1.5 active members for each retiree.

Concerning assets, Mr. Conradi said the return on market in fiscal year 2009 was -27 percent. He said that as far as Gabriel Roeder Smith & Company can tell, this is the worst market return in the fund's history. He said a return this bad is expected to occur just once a century, based on most capital market assumption sets. He said the -27 percent return is made worse because it follows a -7 percent return for fiscal year 2008. He said the fund assumes assets will earn 8 percent per year net of expenses. Thus, he said, the shortfall is really -35 percent or -27% - 8% = -35%. He noted the average return for the last 10 years was 2.0 percent and the 20-year average return was 6.6 percent, which is below the 8.0 percent assumed rate of return. In dollar terms, the shortfall was $632 million, he said.

Mr. Conradi said the fair market value of assets decreased from $1.846 million on June 30, 2008, to $1.310 million on June 30, 2009, or $536 million. He said contributions total $74.4 million and distributions total $118 million. Therefore, he said, the fund has a net external cashflow, contributions less benefits and refunds, of -$43.7 million or -3.3 percent of market value of assets at the end of the year. Although this has not been a problem in the past, he said, projections show the negative net external cashflow increasing in the future. If this occurs, he said, it may require adjustments to asset allocation to meet benefit payments with the fund required to hold more fixed income or cash assets resulting in lower expected returns.

Mr. Conradi said all actuarial calculations are based on the actuarial value of the assets and not market value. He said the actuarial value reflects 20 percent of the difference between last year's expected return on market and the actual return. He said the actuarial value of the fund is now $1.9 million versus $1.909 million last year. He said the actuarial return was 1.7 percent in fiscal year 2009 compared to a -27 percent on the market value of assets. He said the actuarial value is 145 percent of fair market value compared to 103 percent last year. However, he said, there are $590.6 million in deferred losses, which are not yet recognized.

Concerning the actuarial results, Mr. Conradi said the unfunded actuarial accrued liability increased from $421.2 million to $545.6 million. He said the funded ratio, actuarial assets divided by actuarial accrued liability, decreased from 81.9 percent to 77.7 percent. He noted the funded ratio using market value is 53.5 percent, down from 79.2 percent. He said the unfunded actuarial accrued liability is 124 percent of covered payroll compared to 100.8 percent last year. He said the negative margin or shortfall declined from -.99 percent to -2.53 percent, or 8.25 percent, the statutory contribution rate, - 10.78 percent, the actuarial required contribution, = -2.53 percent. He said the funding period based on an employer contribution rate of 8.25 percent is infinite, and the 5.74 percent amortization payment is insufficient. He noted the ending period would be infinite even if the 8.75 percent contribution rate was used.

Mr. Conradi said Gabriel Roeder Smith & Company has prepared projections based on seven possible investment returns for fiscal year 2010, from a -24 percent to a +24 percent. He said the projections assume an 8 percent annual return for fiscal year 2011 and each year thereafter. He said the projections assume there will be no noninvestment actuarial gains or losses, a .5 percent annual decrease in the number of active members, an 8.75 percent employer contribution rate effective in fiscal year 2011 and each year thereafter, and no other benefit or contribution changes. Based on these assumptions, he said, the projection shows that the fund would run out of money in 15 to 35 years. Only with a 24 percent return for fiscal year 2010 will the trust have assets remaining after 30 years, he said. He said the 8.75 percent employer contribution rate never sunsets, the margin never becomes positive, the unfunded actuarial accrued liability continues to grow in the future, and funded ratios all reach or are headed to 0 percent. In order to return to an 82 percent funded ratio by the year 2039, he said, the fund would need to achieve a 58 percent return in fiscal year 2010 followed by a constant 8 percent return thereafter; 17.25 percent for each of the next five years, followed by a constant 8 percent return thereafter; or a 10.75 percent return for every year from fiscal year 2010 through fiscal year 2039. With no recovery and no other changes, he said, to achieve an 82 percent funded ratio in 2039, the employer contribution rate would need to increase to 18.25 percent on July 1, 2011. If nothing is done, he said, the projected benefits in fiscal year 2035 will cost $341 million and require an employer contribution rate of almost 28 percent just to pay that year's benefits. He said North Dakota is not unique in that markets have had this kind of effect on almost all public sector retirement plans, plans across the country are struggling with what to do, and actions available depend on the legal environment in each state.

Concerning what other states are doing, he said, most states are doing or considering forming task forces or pension commissions, increasing employer contributions, looking for other revenue sources, cutting workforces, reducing benefits, increasing retirement ages, creating new tiers with lower benefits, making significant asset allocation changes, establishing longer amortization periods, and changing to an asset valuation method.

In response to a question from Representative Drovdal, Mr. Conradi said the Teachers' Fund for Retirement does not contain any automatic cost-of-living adjustment or increase provisions.

In response to a question from Senator Kilzer, Mr. Conradi said most state teacher retirement plans are a defined benefit plan with a retirement formula based on a multiplier. He said the average multiplier is 2 percent, the same as North Dakota's Teachers' Fund for Retirement.

Chairman Grande recognized Ms. Fay Kopp, Deputy Executive Director, Retirement and Investment Office. She distributed a schedule of North Dakota school districts not covered by Social Security (Appendix D), a memorandum concerning the $14.5 million transfer from the general fund to the Teachers' Fund for Retirement in 1977 (Appendix E), and a history of Teachers' Fund for Retirement retirement plan changes (Appendix F). She said that as of June 30, 2009, there are 14 North Dakota school districts not covered by Social Security with 172 teachers not covered by Social Security. She said in 1977 the Legislative Assembly transferred $14.5 million from the general fund to the Teachers' Fund for Retirement to offset the increasing unfunded liability and decreasing solvency of the fund caused by a series of benefit increases that were given to members without funding the cost.

Chairman Grande recognized Mr. Brad Ramirez, FSA, MAAA, FCA, EA, Consulting Actuary, The Segal Company, San Francisco, California. He presented the results of the July 1, 2009, actuarial valuation of the Public Employees Retirement System (Appendix G). A copy of the actuarial valuation is on file in the Legislative Council office. He said the purposes of the actuarial valuation are to report the plan's assets, estimate the plan's liabilities, determine the recommended contribution for 2009, provide information for annual financial statements, and identify emerging trends. To conduct the actuarial valuation, he said, actuaries gather data as of the valuation date, project a benefit for each member for each possible benefit, apply assumptions about economics and people, apply assumptions to benefits to determine a total liability and assign liabilities to service, and apply the funding policy to determine the recommended contribution. Concerning 2008-09, he said, there was a significant drop in assets in the fourth quarter of 2008. He said changes to contribution rates and funded ratios were dampened by smoothing methods, but the drop in assets still had a significant effect.

Concerning the July 1, 2009, valuation results, Mr. Ramirez said, the market value of the combined assets for the Public Employees Retirement System and the Highway Patrolmen's retirement system was $1.361 billion as compared to $1.817 billion the year before. He said the combined actuarial value of assets for the Public Employees Retirement System and the Highway Patrolmen's retirement system was $1.667 billion as compared to $1.661 billion last year. He said the total actuarial value of assets was 122.5 percent of market value of assets on July 1, 2009. He said significant unrecognized losses will be recognized in subsequent valuations and yield increases in required contributions, unless offset by future gains.

Concerning membership, Mr. Ramirez said, the number of active employees in the main system increased by 3 percent to 19,686, the judges' retirement system remained stable at 47 members, there was a 12 percent decrease in National Guard members, a 6 percent increase in law enforcement with prior service members, stable membership in the law enforcement without prior service plan, and a 3 percent overall increase to 19,943 members. He said there are 6,416 pensions in force for the main system, 22 for the judges' retirement system, 7 for the National Guard retirement system, 16 for the law enforcement with prior service system, and 0 for the law enforcement without prior service plan. He said the average monthly benefit for the combined system is $891.

Concerning financial information for the Public Employees Retirement System, Mr. Ramirez said, the market value of assets decreased from $1.761 billion to $1.320 billion, the actuarial value of assets increased from $1.610 billion to $1.617 billion, and the ratio of actuarial value to market value is 122.5 percent.

Mr. Ramirez said the contribution margin for the main system is -3.62 percent, 4.04 percent for the judges' retirement system, 2.79 percent for the National Guard retirement system, -.80 percent for the law enforcement with prior main service system, and -.40 for the law enforcement without prior main service system. He said the funded ratio for the main system is 85 percent, 111 percent for the judges' retirement system, 112 percent for the National Guard retirement system, 70 percent for the law enforcement with prior service system, and 62 percent for the law enforcement without prior service system.

In response to a question from Representative Wolf, Mr. Sparb Collins, Executive Director, Public Employees Retirement System, said contributions are split between the employer and the employee with the employer paying 4.12 percent and the employee paying 4.0 percent. For some employers, such as the state, he said, the employer "picks up" the employee contribution in lieu of a salary increase.

In response to a question from Senator Nelson, Mr. Collins said the members of the National Guard retirement system are security officers and firefighters not subject to deployment, and thus, the membership in the system is relatively stable.

Concerning the Highway Patrolmen's retirement system, Mr. Ramirez said, the number of actives increased from 130 to 133, an increase of 2.3 percent. He said the number of pensioners and beneficiaries also increased from 105 to 109, an increase of 3.8 percent. He said the average monthly benefit for the Highway Patrolmen's retirement system is $2,542. He said the market value of assets of the Highway Patrolmen's retirement system decreased from $55.6 million to $41 million. He said the actuarial value of assets decreased from $50.8 million to $50.2 million. The ratio of actuarial value to market value, he said, is 123 percent, a difference of $9.2 million. He said the valuation results for the Highway Patrolmen's retirement system show a contribution margin of -2.03 percent of payroll. He said the Highway Patrolmen's retirement system is 87 percent funded. He said the contribution margin for the retiree health insurance credit fund is .14 percent.

In conclusion, Mr. Ramirez said, the asset smoothing and amortization method employed by the Public Employees Retirement System has dampened the effects of last year's losses as intended. However, he said, significant asset losses will be recognized over the next five years, potentially leading to increased contribution requirements. He said potential risks to the system include a continued aging of the population, unforeseen demographic shocks, and a change in asset return environment. He recommended the board consider projections and studies to help quantify these risks and make changes to the system, if appropriate. Also, he said, the asset valuation method should be reviewed.

Mr. Ramirez also reviewed projections for the Public Employees Retirement System (Appendix H). Based upon a market return for each year after fiscal year 2010 of 8 percent, he said, if the market return for fiscal year 2010 is 24 percent the available margin on June 30, 2010, will be -4.43 percent declining to -7.18 percent on June 30, 2014. If the market return for fiscal year 2010 is 16 percent, he said, the margin on June 30, 2010, will be -4.63 percent declining to -8.21 percent on June 30, 2014. If the market return for fiscal year 2010 is 8 percent, he said, the June 30, 2010, margin will be -4.83 percent declining to -9.24 percent on June 30, 2014. If the market return for fiscal year 2010 is 0 percent, he said, the margin on June 30, 2010, will be -5.03 percent declining to -10.26 percent on June 30, 2014. He also calculated available margins based upon a market return for fiscal year 2010 of -8 percent, -16 percent, and -24 percent. He said if the market return after fiscal year 2010 is always 9.3 percent, the projected margins for 2010 through 2014 are always negative.

Chairman Grande recognized Mr. Aaron Webb, Assistant Attorney General, Attorney General's office. He discussed constitutional implications of reducing benefits or increasing contributions for existing members of public employee retirement plans (Appendix I). He said the legality of benefit structure changes is an evolving area of law, and the two questions asked are whether member contribution levels may be increased and whether member benefits may be decreased. In essence, he said, the questions ask whether the state of North Dakota would have the authority or power to unilaterally change the benefit structures contained within the current law to the disadvantage of any Public Employees Retirement System or Teachers' Fund for Retirement member or what legal entitlement a Public Employees Retirement System or Teachers' Fund for Retirement member has to the terms of his or her pension. He said courts review constitutional provisions, existing retirement statutes and rules, prior case law, policy grounds, plans, and a combination of these factors in determining legal entitlement to pensions. He said there are three main entitlements theories, which may be categorized as the gratuity theory, qualification or trigger theory, and contracts theory. Under the gratuity theory, he said, pensions are a gift; legislative modification or elimination of the retirement benefit structures can be made without regard to the employee's interest in those benefits. Under the qualification theory or trigger theory, he said, public employees vest for the purposes of protection under the contracts clause once specific requirements are met for that member to secure a pension benefit under the retirement statutes. Up to that point, he said, the member has no protection. Under the contracts theory, he said, retirement benefits are considered earned compensation contracted for at the time of employment, the terms of which are either completely protected or only subject to modification under limited circumstances. He said the legal landscape has evolved from the gratuity theory of the early 20th century to a minority contracts approach in the 1960s to a majority contracts approach under current law. He said the trend is moving toward more protection for the employee. He said there is only one and at most two states that still follow the gratuity theory. He said several states follow the qualification theory, and the majority follow the contracts approach. In summary, he said, if the Legislative Assembly does not make changes modifying existing benefit structures to the members' detriment, such as increases to the contribution levels of active members or reductions to member benefits, no constitutional challenge would occur. He said this is the most defensive position for the state. However, he said, if the Legislative Assembly makes a decision to modify existing benefit structures to the members' detriment, depending on the level of change and membership subject to the change, the action could trigger a constitutional challenge whereby a court would need to make a decision based on modern law. He said this would be a potential risk for the state. He said it is clear that the Legislative Assembly can make changes for new or future hires and that retirees are absolutely protected even under the old theories. However, he said, the risk would increase as the Legislative Assembly made changes to nonvested employees, vested employees, or vested employees eligible to retire.

No further business appearing, Chairman Grande adjourned the meeting at 1:15 p.m.

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Jeffrey N. Nelson
Committee Counsel

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