#373

Report To
The Mississippi Legislature

An Evaluation of Statements of the Board of the Public Employees' Retirement System Regarding the Actuarial Status of the System

January 5, 1998

The Board of Trustees of the Public Employees' Retirement System (PERS) places too much emphasis on the amortization period of the unfunded accrued actuarial liability as a measure of the system's funding status. The board should also use the ratio of unfunded actuarial accrued liability to covered payroll as a measure of the system's health, because this ratio directly relates to the funding stream that supports PERS.

PEER's actuary states that reasonable differences of opinion may exist over the need for changes in the PERS cost of living adjustment or for ad hoc benefit increases for current retirees and recommends that any increase in benefits be funded wholly or partly by an increase in contributions rather than exclusively by an extension of the amortization period of the unfunded accrued actuarial liability.

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An Evaluation of Statements of the Board of the Public Employees' Retirement System Regarding the Actuarial Status of the System

January 5, 1998

The PEER Committee

Mississippi Legislature

The Mississippi Legislature

Joint Committee on Performance Evaluation and Expenditure Review

PEER Committee

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January 5, 1998

Honorable Kirk Fordice, Governor
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Members of the Mississippi State Legislature

According to MISS. CODE ANN. Section 25-11-101 (1972), the PEER Committee is required "to have performed random actuarial evaluations, as necessary, of the funds and expenses of the Public Employees' Retirement System and to make annual reports to the Legislature on the financial soundness of the system."

The PEER Committee engaged Bryan, Pendleton, Swats & McAllister, LLC, to prepare the enclosed review of statements and pronouncements of the Public Employees' Retirement System in light of the system's 1996 actuarial audit. PEER released this report, entitled An Evaluation of Statements of the Board of the Public Employees' Retirement System Regarding the Actuarial Status of the System, at its January 5, 1998, meeting.

Senator Ezell Lee, Chairman

This report does not recommend increased funding or additional staff.

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Executive Summary

PEER commissioned an independent actuary to review public statements by the Board of Trustees of the Public Employees' Retirement System (PERS) to determine whether the statements accurately reflect the actuarial status of the system and the adequacy of benefits.

PEER's actuary found that when discussing the system's health, the board places too much emphasis on the amortization period of the unfunded accrued actuarial liability as a measure of the system's funding status. This measure tends to inspire calls for increased pension benefits without proper consideration for the long-term funding of the system. The board should use the ratio of unfunded actuarial accrued liability to covered payroll as a measure of the system's health. Since the system's funding is calculated as a percentage of payroll, this measure directly relates to the funding method.

Although PEER's actuary states that the current method of calculating the annual Cost of Living Adjustment (COLA) has not resulted in inequity, the actuary states that reasonable differences of opinion may exist over the need for changes in the PERS COLA or for ad hoc benefit increases for current retirees.

The actuary recommends that the PERS Board use a combination of measures of funding progress when publicly discussing the actuarial status of the system and that any increase in benefits should be funded wholly or partly by an increase in contributions rather than exclusively by an extension of the amortization period of the unfunded accrued actuarial liability.

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An Evaluation of Statements of the Board of the Public Employees' Retirement System Regarding the Actuarial Status of the System

The PEER Committee Commissioned Bryan, Pendleton, Swats & McAllister, LLC, to review statements and pronouncements of the Public Employees' Retirement System of Mississippi in light of the 1996 Actuarial Audit of the system.

The purpose of this review is to determine whether the public statements by the board, its committees, and its staff are accurate and not misleading with respect to the adequacy of benefits and the actuarial status of the system.

Findings

The Public Employees' Retirement System (PERS) has placed too much emphasis on the amortization period of the Unfunded Actuarial Accrued Liability (UAAL) as a measure of the funded status of the system. In most instances, it is the most prominent and, oftentimes, only measure of funding progress communicated to members. PERS should communicate a more appropriate measure of funding progress to members so that they may better understand the funding status of the system.

Several PERS Board members are recommending using increases in the amortization period of the UAAL as a way to pay for benefit improvements. To maintain the integrity of the system, we recommend that any benefit increases be paid for wholly or partly by increases in contribution rates.

Introduction

As commissioned, we have reviewed statements and pronouncements of the Public Employees' Retirement System of Mississippi (PERS) in light of the findings of the 1996 Actuarial Audit of the system. The items reviewed include the following:

- **PERS's newsletters to members published during 1996 and 1997.**
- **Comprehensive Annual Financial Reports for the fiscal year ending in 1996.**
- **Actuarial valuations for fiscal years ending 1996 and 1997.**
- **Minutes from PERS board meetings where results of actuarial valuations for 1996 and 1997 were presented to PERS board.**
- **Minutes from the legislative committee of PERS's board.**

- **PERS's most recent budget request.**

- **Pronouncements or statements by PERS to legislative bodies concerning the financial status of the system or adequacy of benefits.**

- **Copy of investment objectives and asset mix objectives as established by PERS board.**

Definitions for underlined terms may be found at the end of this report.

Information Communicated to Members

An area of concern is the continued use of the amortization period of the Unfunded Actuarial Accrued Liability (UAAL) as the primary measure of the funded status of the system. Even though much more meaningful measures of funding progress are produced by the Annual Actuarial Valuation, it is the amortization period of the UAAL that makes it to the front page of the system's newsletter for active members and retirees.

For example, the December 1996 PERS Member Newsletter included a front page graph comparing the amortization periods for 1995 and 1996 for PERS, the Mississippi Highway Safety Patrol Retirement System, and the Supplemental Legislative Retirement Plan.

Continued use of the amortization period of the UAAL as the single most prominent measure of the system's funding progress is not appropriate. The Governmental Accounting Standards Board (GASB) recently issued Statements No. 25 and No. 27 which cover disclosure and accounting for systems such as PERS. The "Schedule of Funding Progress" as defined by GASB in Statement No. 25 does not include disclosure of the amortization period of the UAAL. It would seem safe to say that GASB does not place the same level of importance on the amortization period that PERS has through its periodic newsletters to members and retirees.

In the December 18, 1990, PEER Report on PERS, Thomas P. Bleakney, F.S.A., a consulting actuary with Milliman & Robertson, Inc., stated, "These findings suggest considering alternatives to the use of amortization periods for measuring the progress of the financing of the System. . . ."

A number which is part of the disclosure in GASB Statement No. 25 and which would be a more appropriate measure of funding progress is the UAAL as a percentage of Covered Payroll. Generally, the lower the percentage of UAAL to covered payroll, the stronger the system. The following is a portion of the Schedule of Funding Progress taken from the PERS June 30, 1997, Annual Actuarial Valuation, with information added for 1988.

Table 1

Schedule of Funding Progress

(In Thousands)

Plan Year Ended	Unfunded ALL	Annual Covered Payroll	UAAL as % of Payroll
6-30-88	$1,012,046	$1,826,922	55.4
6-30-91	2,889,833	2,499,679	115.6
6-30-92	2,960,726	2,493,315	118.8
6-30-93	2,950,984	2,608,207	113.1
6-30-94	3,427,112	2,864,807	119.6
6-30-95	3,045,769	2,979,260	102.2
6-30-96	2,546,502	3,185,289	79.9
6-30-97	2,329,634	3,294,731	70.7

On June 30, 1988, the UAAL as a percentage of payroll for PERS was 55.4%. In a six-year period, the percentage increased to nearly 120% of payroll. Benefit improvements are the primary reasons for the increase in the percentage from 1988 to 1994.

The funding progress of PERS has improved since 1995 primarily due to the historic bull market in equities over the last two years. The current percentage of 70.7% may indicate that PERS is now more in line with similar systems. In 1994, the average for 68 systems similar to PERS of the UAAL as a percentage of payroll was 56.1%.

Benefit Improvements Under Consideration

In recent years, PERS has funded all or part of benefit increases by increasing the amortization period of the UAAL. Following the recent decline in the amortization period, the Legislative Committee of the PERS board has discussed a long-range plan for benefit improvements. The Committee is composed of board members who consider legislation for possible recommendation to the Legislature. Our concern is that benefit increases are purchased with extensions of the amortization period of the UAAL, thereby making benefit improvements an apparently painless process. This approach takes a very short-term view of the system's funding progress. As is apparent from the above chart, the funding status of the system can change dramatically over relatively short periods.

Two benefit improvements under consideration involve a change in the cost of living adjustment for retirees (COLA) and an ad hoc benefit increase for current retirees.

Proposed Changes to Cost of Living Adjustment

The current COLA formula is an arithmetic COLA that takes into account increases in the Consumer Price Index up to 2.5%. In an arithmetic COLA, each year's benefit increase is applied to the original benefit. In a geometric COLA, such as used by Social Security, each year's increase is applied to the current benefit.

The following table compares the cumulative COLA benefit increase for PERS to a system which gives the full Consumer Price Index (CPI) on a geometric basis using the actual history of the CPI and COLAs under PERS. A large portion of a member's benefit is provided through Social Security, which is adjusted each year for the full CPI. To prepare our table, we assumed a married member retiring at age 65 with earnings of $20,000 in his final year, a fairly typical example. For this member, approximately 60% of his total retirement benefit would come from Social Security. For $100 of initial benefit, we applied the Social Security COLA (geometric COLA) to the first $60 of benefit and the PERS COLA to the next $40 of original benefit.

Table 2

Example of the Effect of PERS's Use of an Arithmetic COLA Compared to Effect of a Geometric COLA

Years of Retirement Prior to 1997	Monthly Benefit Under: 60% Geometric COLA 40% PERS COLA	Geometric COLA Equal to full CPI	
	A	B	A/B
One	$100	$100	100%
Five	113	114	99%
Ten	137	144	95%
Fifteen	157	169	93%
Twenty	223	273	82%

The above chart indicates that the combination of the Social Security COLA and PERS COLA has done a reasonable job of maintaining standards of living for retirees. Only during periods of extreme inflation have the combination of Social Security and PERS fallen behind. This is reflected in the above by the change of 93% to 82% for years fifteen to twenty. This is a result of double digit inflation in the late 70's and early 80's.

In addition to this COLA, the Base COLA Percentage, the current law allows PERS to grant an additional COLA percentage in years when PERS experiences investment gains as certified by the PERS actuary. This additional percentage is a discretionary amount granted in multiples of a 1/4% up to 1.5%, independent of actual increases in the Consumer Price Index. The above chart

does not take into account the discretionary increase of 1.5% which has been approved by the PERS board for the last two years.

Changes sought by PERS would be to change the COLA to a geometric COLA, possibly recognizing increases in the Consumer Price Index in excess of 2.5%, and removing the discretionary additional COLA based on investment gains. For retirees under the current benefit formula, the current COLA arrangement should provide adequate protection under normal periods of inflation. We concur with the removal of the discretionary COLA amount.

Ad Hoc Benefit Increases

There seems to be some misunderstanding concerning granting of discretionary benefit increases. Even though the increase is discretionary, that does not make it free. Subject to funding constraints, benefits should be designed to be adequate for current retirees and for retirees who have been retired for several years. Making benefits adequate should not be dependent on investment gains in one year. If benefits are adequate, then the merits of distributing current investment gains to current retirees is questionable.

In addition to changes in the COLA formula, the board has discussed an ad hoc benefit increase for current retirees. As noted in the minutes of the Legislative Committee Meeting of the PERS Board, for the current group of retirees the average monthly retirement benefit is $709 with the average years of service at retirement of 24.63 years.

Based on the benefit formula in effect since 7/1/89, we can analyze the adequacy of retirement benefits for a typical member retiring at age 65. A participant with final average earnings of $18,150 and 25 years of service would have a monthly benefit of $709 a month at age 65--i.e., the average benefit described above. Based on the 1992 Benefit Adequacy Study prepared by the PERS actuary, a married participant retiring with 25 years of service at age 65 with earnings between $15,000 and $20,000 would have disposable income after taxes equal to 125% of his or her pre-retirement disposable income. Therefore, the $709 monthly benefit represents a more than adequate retirement benefit for our example member.

Based on the June 30, 1997, PERS Actuarial Valuation, 49% of all current retirees have retired since June 30, 1989. In the 1989 round of benefit changes, all members retiring before July 1, 1989, received a 5% ad hoc benefit increase. In addition, 63% of current retirees were never required to contribute to the system at the rate of 7.25% of pay, the current member contribution rate.

Methods of determining the ad hoc increase, as discussed by the Legislative Committee, do not take into account the age at which the member elected to retire. There does not seem to be much justification to granting additional benefits to members who voluntarily elected to retire early under the system's liberal early retirement provisions, some of whom may even be pursuing second careers.

There does not seem to be much evidence that benefits at time of retirement from the system for long-term employees retiring at ages 62 or later have been historically inadequate. Loss of any benefits through inflation should be addressed through the formula for annual COLAs. Granting ad hoc benefit increases for current retirees could produce results that are contrary to employer goals and produce inequities among groups of members, both active and retired.

Conclusion

We believe that overemphasis of the amortization period of the UAAL has produced a climate in which extension of the amortization period is viewed by some as currency which may be used to purchase additional benefits in a painless manner. It is almost analogous to buying benefits on credit. As anyone knows, too much credit can be a dangerous thing. Reasonable differences of opinion may exist over the need for changes in the PERS COLA or ad hoc benefit increases for current retirees. To maintain the integrity of the system, we recommend that any benefit increases be purchased wholly or partly by increases in contribution rates. In addition, we recommend that PERS communicate a more appropriate measure of the funded status of the system to members.

The real challenge for PERS over the next several years will be how it handles the system's improved financial condition resulting from the recent historic equity bull market.

Recommendations

PERS has placed too much emphasis on the amortization period of the Unfunded Actuarial Accrued Liability (UAAL) as a measure of the funded status of the system. In most instances, it is the most prominent and, oftentimes, only measure of funding progress communicated to members. PERS should communicate a more appropriate measure of funding progress to members so that they may better understand the funding status of the system.

Reasonable differences of opinion may exist over the need for changes in the PERS COLA or ad hoc benefit increases for current retirees. To maintain the integrity of the system, we recommend that any benefit increases be purchased wholly or partly by increases in contribution rates.

Definitions

Actuarial Cost Method is a budgeting process that assigns a cost of the benefits payable under the system to prior, current, and subsequent plan years. The cost of the benefits payable determined as of a specific date is referred to as the present value of benefits.

Normal Cost is the annual cost assigned to current and subsequent plan years by the actuarial cost method.

Actuarial Accrued Liability is the portion of the present value of benefits which is not provided through future Normal Costs. The Actuarial Accrued Liability, at any particular time, is equal to the present value of future benefits less the present value of future Normal Costs.

Actuarial Valuation or Valuation is the determination, as of a valuation date, of the Normal Cost, Actuarial Accrued Liability, Actuarial Value of Assets and related Actuarial Present Values for a pension plan.

Unfunded Actuarial Accrued Liability is the excess of the Actuarial Accrued Liability over assets. In this report we refer to the Unfunded Actuarial Accrued Liability as the UAAL.

PERS

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December 31, 1997

Mr. Max Arinder
Executive Director
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Re: Response to Draft of Evaluation of Statements of the Board of the Public Employees' Retirement System Regarding the Actuarial Status of the System

Dear Mr. Arinder:

PERS staff recently reviewed a copy of the proposed draft of the above Evaluation in your office. We note that the purpose of the review was to determine if the public statements by the Board, its committees and its staff, are accurate and not misleading with respect to the adequacy of benefits and the actuarial status of the System. In reviewing the Evaluation, we are unable to determine whether the author determined that such public statements were accurate and not misleading. PERS was hopeful that there would be a clear finding based on the stated purpose of the Evaluation, as it is PERS intent to always provide the public and our members with accurate information.

The following comments are in response both to some of the statements contained in the report as well as to its conclusions.

First, with regard to some of the specific statements contained in the report, the section on Information Communicated To Members addresses only one avenue of our communication to the public and our membership. The report states that PERS uses the amortization period of the Unfunded Actuarial Accrued Liability (UAAL) as the primary measure of funding progress and that continued use of such "as the single most prominent measure of the System's funding progress is not appropriate." In both the 1996 and 1997 PEER Actuarial Reviews, it is clear that the author is biased toward expressing funding progress as the UAAL as a percent of covered payroll. However, we do not feel that such measure is more accurate than the UAAL amortization period nor that it has any advantages when communicating the actuarial status of the fund to members.

We would point out that the PERS Annual Report, which is provided to every legislative member of our System and which is available to all our members upon request, shows the following with regard to "other valid measures" of PERS actuarial status:

1997 Annual Report

Page 22 - Graph reflecting five years of PERS Funded Ratio
Page 22 - Graph reflecting five years of PERS UAAL Period
Page 12 - Discussion of "funding ratio"

1996 Annual Report

Page 24 - Graph reflecting five years of PERS Funded Ratio
Page 23 - Graph reflecting five years of PERS UAAL Period
Page 12 - Discussion of "funding ratio"

1995 Annual Report

Page 24 - Graph reflecting five years of PERS Funded Ratio
Page 23 - Graph reflecting five years of PERS UAAL Period
Page 80 - Letter from the Actuary regarding status of the System
Page 12-13 - Discussion of "funding ratio"

1994 Annual Report

Page 22 - Graph reflecting five years of PERS Funding Ratio
Page 22 - Graph reflecting five years of PERS UAAL Period
Page 10 - Discussion of "funding ratio"

1993 Annual Report

Page 22 - Graph reflecting eight years of PERS Funding Ratio
Page 22 - Graph reflecting ten years of PERS UAAL Period
Page 12 - Discussion of "funding ratio"

Further, as the PEER Committee is well aware, our membership covers a wide spectrum of public employees including highway road crewmen and engineers, public school teachers, cafeteria workers, janitorial staff, bus drivers, state employees, law enforcement officers, staff of the Institutions of Higher Learning, elected officials, municipal and county employees. Thus, in communicating with our membership at large, it is PERS' objective to provide our members with pertinent information in the most **understandable** format or presentation, considering the vast diversity in educational background of all 300,000 members and retirees served by PERS.

Thus, with regard to using the amortization period as a measure of funding progress, we would agree that there are other valid measures and that these should also be used where appropriate. That is why PERS has such information included in the Annual Actuarial Valuation and why such information is included in the Annual Report.

The Report states that there are "... **much more meaningful** measures of funding progress". However, the funding ratio, the ratio of unfunded accrued liability to payroll and the amortization period would all be expected to move in the same direction, albeit by differing amounts. Having said that, PERS has found that the movement in the amortization period is one of the easier tools to understand and to measure. Thus, this is the measure which we feel is most appropriate for communication to the general membership through newsletters and which, in our experience, is the measure primarily used by the majority of other retirement systems. However, as noted above, other measures are reflected in other PERS publications.

Second, the section on Benefit Improvements under Consideration states that "Our concern is that benefit increases are purchased with extensions of the UAAL, thereby making benefit improvements an apparently painless process." The Conclusion and Recommendation states that "We recommend that any benefit increases be purchased in all or in part by increases in the contribution rates."

We would agree that it would be better from a funding perspective to finance benefit improvements with increases in current contribution rates. We do so because it is actually cheaper in the long run to pay "up front" so as to take advantage of the real returns on assets to help finance the liabilities. However, the funding of the System is not jeopardized by extending the amortization period (within acceptable bounds), and the level of current contributions is a policy decision for the State Legislature. The State Legislature must consider the budgetary impact, not only on the State but also on participating political subdivisions in determining how to finance benefit improvements. The decision is ultimately that of the Legislature, unless such improvement would make the System actuarially unsound, in which case the Board, based on recommendation from the Actuary, would have to adjust the contribution rate.

Third, the Report also notes that the "funding progress of PERS has improved since 1995 primarily due to the historical bull market in equities over the last two years." While we agree that the primary reason for the relatively large improvement in funding recently has been the return on system assets, it is not the only reason. Adhering to the required contribution levels has also improved funding. We believe the point is that the funding has improved. In fact, with one exception, the funding ratio has improved each year over the last six in spite of benefit improvements and discretionary COLA payments in most of those years.

Fourth, in the Report's discussion of Ad Hoc Benefit Increases, the author comments that "there seems to be some misunderstanding concerning granting discretionary benefit increases. Even though the increase is discretionary, that does not make it free." We would respond that there is no misunderstanding of this on the part of PERS. In fact, it is the Legislature which enacted the "discretionary" portion of the current COLA structure which, by its nature, cannot be anticipated or factored into the actuarial funding status in advance. However, each time a discretionary COLA is certified, the Board clearly understands that the financial impact or cost of such discretionary COLA cannot be reflected until the following Annual Actuarial Valuation. Thus, no one with the PERS Board or administration suffers from a misunderstanding that such discretionary COLA's are "free."

An example used in the section on Ad Hoc Benefit Increases illustrates the adequacy of retirements for a typical member retiring at age 65. The author notes that, "A participant with final average earnings of $18,150 and 25 years of service would have a monthly benefit of $709.00 a month at age 65, i.e., the average benefit as described above. Based on the 1992 benefit adequacy study, prepared by the PERS Actuary, a married participant retiring with 25 years of service at 65 with earnings between $15,000 and $20,000 would have disposable income after taxes equal to 125% of his or her preretirement disposable income. **Therefore, the $709.00 monthly benefit represents a more than adequate retirement benefit for our example member."**

We take exception and strongly disagree with the presentation and conclusion. The author glaringly fails to note in making such statements that retirement programs such as PERS require mandatory member contributions. Consequently, these member contributions must also be taken into account, as a portion of the retirement benefits are purchased through these forced member savings. Moreover, inflation reduces the purchasing power of income, and can have a significant detrimental effect on a retiree's standard of living. This is particularly true since PERS benefit is not fully indexed to the changes in inflation, and because inflation has had, and is expected to continue to have, a greater impact on the cost of health care, which costs tend to increase significantly in retirement, than on other costs a retiree may incur. The author fails to mention the replacement ratios based on the portion of PERS and Social Security benefits that are financed by **employer** contributions only and instead makes a comparison based on benefits purchased by the member himself. The Benefit Adequacy Study clearly points out that no age, marital status, service and salary combination exhibits an **employer-financed** replacement ration above 100%. In fact, none were above 85%. We feel that for purposes of this report, employer-financed benefits are a more appropriate measure of replacement ratio. However, given that, we would further take exception with the statement that $709 per month" represents a more than adequate retirement benefit" for a career state employee, when in fact such level of income is well below the national poverty level.

The report states that ". . . PERS has funded all or part of benefit increases by increasing the amortization period of the UAAL." We would remind the Committee that the 1991 amendment to allow retirement at 25 years regardless of age was financed by a ¾% increase in the employee contribution rate. Further, in providing information to the legislature on recommended changes in the PERS law, the actuarial impact both in terms of change in the amortization period as well as the cost in terms of the change in the contribution rates are provided to the legislature.

The tenor of the report seems to lay criticism on the Board for discussing long-range plans for benefit improvements for its members. Each year, many, many bills are introduced into the legislature to enhance benefits. The Board serves in a fiduciary capacity to the fund. As such, it feels that it is its duty to thoroughly investigate all alternatives presented to it. In fulfilling this role of "due diligence", the Board must fully explore, study and discuss alternatives. Much of this exploratory discussion is done at the Committee level, sometimes over a period of years. Rather than being criticized for discussing such items as benefit improvements and financing alternatives for such improvements, it is felt that the Board should be commended for, and indeed encouraged to, carefully study and discuss various alternatives for accomplishing such goals.

In conclusion, the Report states that there can be reasonable differences of opinion regarding adequate COLA provisions and ad hoc benefit improvements. And we agree.

Sincerely,

Frank Ready

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