MISSISSIPPI

Governor's Public Employees' Retirement System Study Commission

Recommendations on Ways to Strengthen the State's Retirement Plan

I. Executive Summary

Governor Haley Barbour established the Public Employees' Retirement System (PERS) Study Commission to review the public pension program and offer recommendations to protect its solvency for future generations. In this report, the Commission presents recommendations in three critical areas: management, legal, and investment and finance. The report also includes a series of general retirement policy recommendations for consideration by the Governor, Legislature and the PERS Board of Directors.

State public pension programs across the nation face significant fiscal challenges meeting the demands of current retirees, managing smaller market returns over the past decade and preparing for a large number of government workers approaching retirement age. Mississippi shares in these struggles to manage its current needs while ensuring there is still a retirement system in the future to serve young state workers today.

PERS relies on contributions from both employees and taxpayer-funded employers (state agencies, universities and school districts), as well as investment returns, to provide the necessary funding to pay for benefits for thousands of Mississippians. Taxpayer costs to fund the state's retirement system have risen sharply in recent years while employee contributions have remained largely static. The rising costs for government entities are unsustainable and reduce funds for other services, such as education and public safety. Without changes to the current system, increases in employer, or taxpayer, contributions will continue to be significant. For 15 years, the employer contribution rate of 9.75 percent remained steady. However, as concerns over the system's financial solvency grew, the state's contribution to the system rose each year from 2006 to 2010 to its current rate of 12 percent, which will increase to 12.93 percent next month. A sixth rate hike to 14.26 percent will take effect July 2012 if projections hold true. That means the taxpayers' share will increase by almost half – 46.2 percent – over eight years.

Employee contributions were unchanged at 7.25 percent from 1991 to 2010. At Governor Barbour's request, the Legislature authorized an increase in employee contributions to 9 percent in 2011.

Employer rate increases were driven by the persistent growth of unfunded liabilities in PERS, despite significant increases in what taxpayers paid into the system over the same time period. In 2001, unfunded liabilities were just 12.5 percent of assets, and the plan had a funded status of 88 percent – above the threshold most experts consider a healthy level for retirement systems. By 2011, unfunded liabilities had more than tripled to 37.6 percent, and the funded status had dropped to 62.4 percent. The actual dollar amount of this unfunded liability more than quadrupled, rising from $2.3 billion to $12.3 billion. These trends caught the attention of credit rating agencies, which started to question Mississippi's growing total debt load.

Mississippi law requires the Legislature's Performance Evaluation and Expenditure Review (PEER) Committee to perform "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." However, PEER has published no such reports since 2002. Most recently, the PERS Board voted against commissioning an independent study of the system and the Legislature failed to establish its own study committee. As a result Governor Haley Barbour created the PERS Study Commission by executive order to review the state's retirement plan and make recommendations on ways to strengthen the system in the short- and long-term.

The Study Commission, established by Executive Order No. 1061, was chaired by George Schloegel, Gulfport Mayor and former Hancock Bank Chief Executive Officer, and included a wide array of members from state government and the business and legal community, as well as non-voting members of the Legislature.

A healthy retirement system is critical to keep costs reasonable for employers and employees, maintain positive marks from credit rating agencies for the state's ability to meet its obligations; and the state's capacity to provide meaningful and appropriate retirement benefits for members.

Investment and Finance

The Study Commission adopted the following recommendations from the investment and finance subcommittee:

The PERS Board should reconsider lowering its investment return assumption from eight percent to 7.5 percent as recommended by PERS' own actuary, Cavanaugh MacDonald. In its report to the PERS Board, Cavanaugh MacDonald found that the target asset portfolio for PERS "seems to have shifted to a more conservative balance between equities and fixed income at the same time that the capital market assumptions have shifted to lower expected returns for all asset classes" resulting in a "significantly lower return" for PERS investments. Even though the eight percent investment return assumption currently used by PERS falls within Cavanaugh MacDonald's "reasonable range" of returns (6.09-8.62 percent), the actuary firm recommends that PERS lower its investment return assumption from eight percent to 7.5 percent. Over the last ten years, PERS has achieved a 5.41 percent investment return.

Other states have reduced their investment return assumptions according to information provided by Gabriel Roeder Smith & Company (which provided expert actuarial services to the Study Commission) and other sources. According to an October 2011 National Association of State Retirement Administrators (NASRA) Issue Brief ("Public Pension Plan Investment Returns"), 8 percent remains the predominant rate assumption but states have recently lowered their investment return rates. Of the 126 plans in the NASRA survey, 19 had reduced their investment return assumption since Fiscal Year 2008; since Fiscal Year 2001, 44 plans had reduced their rate.

The PERS Board should more regularly review its investment policy to ensure the investment goals strategy reflects current market conditions. These reviews should be conducted in consultation with one or more expert financial consultants.

Continued analysis of the integration of a defined contribution feature in the overall retirement program should be conducted by the Legislature and/or the PERS Board. Such a feature may attract workers to government employment by offering portability in the retirement program.

Management

The Study Commission adopted the following recommendations from the management subcommittee:

The Legislature should authorize and provide resources for the State Auditor to conduct regular, independent reviews of PERS plan risks and performance. Such reviews should occur at least every four years and at any time the Legislature considers changes to plan benefits. The State Auditor should report findings not only to the Legislature, but also to PERS, sponsoring employers, and the general public. This review should be in addition to any review that may be conducted by the PEER Committee or other agent of the Legislature.

The Legislature should consider forming permanent committees to oversee PERS with professional staff knowledgeable of actuarial science and retirement plan requirements and resources to hire independent actuaries. This measure will address a fundamental issue with the current system: clearly assign responsibility for the system. While it is true that a defined body should be responsible for pursuing the day-to-day administration of PERS, it is also true that the responsibility for the substance of PERS rests with the Legislature.

The Legislature should take heed of the "best practice" recommended by the Government Finance Officers Association regarding the balanced representation on retirement boards such as the PERS Board. The PERS Board currently includes ten members, six elected by public employees, two elected by retirees, one appointed by the Governor, and the State Treasurer. Eight of the ten members represent plan participants and retirees and two, the Governor's appointee and the State treasurer, represent the plan sponsor, the State of Mississippi. None represent non-participant citizens, and none are independent directors.

There are several ways to achieve this recommendation:

Option 1: The Legislature could add additional independent members to the PERS Board with senior investment or financial management experience or extensive, senior-level private sector management experience and no direct or indirect interests in the plan. The PERS Board Chairman voted against this option and stated for the record he would not support "any changes to the PERS Board."

Option 2: The Legislature could revise the positions currently held by the State Treasurer and appointed by the Governor to require the Governor and State Treasurer to appoint independent members with senior investment or financial management experience or extensive, senior level private sector management experience and no direct or indirect interests in the plan. This would give voice to non-participant taxpayers even though it would not balance board membership. If this option is selected it should be coupled with the previous recommendation by the study commission to engage an annual review by the State Auditor of the PERS plan.

Option 3: Some states establish independent commissions to administer retirement plan design. The Legislature could form a six-member commission with the Governor, Lieutenant Governor, and/or Speaker of the House appointing three members, each with senior investment or financial management experience or extensive, senior level private sector management experience and no direct or indirect interests in the plan. The PERS Board would select three of its members to serve on the commission. This commission would then assume authority over plan design, inputs, and assumptions used by the plan actuary. Plan operations and implementation along with other ministerial functions would remain under the PERS Board.

The PERS Board should implement a comprehensive risk management system that is compliant with the framework set forth by the Public Plans Practices Task Force of the American Academy of Actuaries. Risk factors should be listed, assessed and published in the PERS annual report. External and independent auditors should review and report on the adequacy of the risk management system. Reports on such a system should be provided to the Legislature.

The Legislature should repeal Section 25-11-143 of the Mississippi Code which requires the PERS Board to establish and fund a healthcare plan for retirees when the PERS plan reaches a certain funding level. The Study Commission believes that retirement assets should be held exclusively by PERS to pay retirement benefits to members and therefore agrees with this recommendation that has been supported by the PERS Board.

Legal

The legal subcommittee provided an analysis of the legality of modifying benefits for members, both current and future, of the PERS plan. The Study Commission voted to accept the legal subcommittee report in its entirety. The legal report provides the following analysis regarding modification of benefit changes, with the caveat that the ultimate determination of the legality of any changes to PERS will rest with the state judicial system.

New hires. The Legislature may apply new standards of retirement to new hires. This is an area of agreement between every reviewer and commentator whose work was examined by the legal subcommittee.

Current employees. Current employees covered by the system have accrued a benefit although it continues to grow with additional service. Some of those employees have completed the service vesting for those benefits, and some have not. It is not likely that "vested" status is determinative of an employee's right to an accrued benefit. Thus, the legal subcommittee believes it is likely that compensation and service earned are accrued benefits with contractual protection. However, the following changes may likely be made: applying a retirement age requirement for future benefit accruals with a reduction for early retirement on those future accruals; removing disability coverage from the system for non-disabled members; requiring the payment of actuarial cost for future purchases of service credit, which is currently in place; modifying the compensation calculation to four consecutive years and limiting the allowable compensation, provided that a baseline accrued benefit is set; eliminating stacking for future accruals; eliminating or reducing leave pay as compensation for future accruals; eliminating the lump sum option for future accruals; reducing the rate of future accruals; and changing the cost-of-living calculation.

Retirees. Retirees have performed service and earned annual accruals. The legal subcommittee believes the great likelihood is that these benefits are protected under the contracts clause. However, the annual three percent increase in benefits is likely a future accrual and not a benefit earned for prior service. Thus, it may be permissible to make a change in future accruals of the three percent cost-of-living adjustment.

Retirement Policy Recommendations

The PERS Study Commission established clear goals for its recommendations:

1. Reduce the overall contributions (employer and employee) to less than 15 percent of pay within seven years
2. Eliminate as many distinctions between new hires and grandfathered employees as possible
3. Structure benefits consistent with a policy that does not encourage participants to stop working for the state or other participating employer prior to age 62
4. Increase funding to a "healthy" (such as 80 percent funded status) over a seven-year period
5. Simplify the administration
6. Lower the vesting period to encourage individuals to seek public employment
7. Ensure best practices in all areas (financial, investment, management, etc) are in place

Affordability of PERS

The Study Commission felt that any recommendations should be developed with an eye toward creating a plan that is fair, affordable to both the beneficiaries and taxpayers, and sustainable in the long-term. The employer's rate has substantially increased in recent years. In fact, the employer's contribution rate will have increased three times over the course of one year, from 12 percent of payroll to 14.26 percent in July 2012 (or an estimated cost to the state of $26.3 million), if current projections hold true. This is an 18.8 percent increase – in one year. The Study Commission believes it is possible to provide a meaningful and reasonable retirement benefit for state, school, county, municipal, and other members without so large a cost to taxpayers as the current PERS system. The Legislature should review the overall cost as part of its monitoring and maintenance of PERS.

Retirement age and eligibility for drawing benefits

The Study Commission voted to recommend modification by the Legislature to provide that 62 would be the normal retirement age with the following tiers for drawing retirement:

- Eligible to draw full retirement at age 62 if vested
- Eligible to draw full retirement at age 55 with 30 years or more of service, but with no cost-of-living adjustment until age 62 or
- Eligible to draw an actuarially reduced benefit before age 55, after completing 30 years of service.

Implementing these changes and lowering the vesting period from eight to four years (effective for current members' future service and all new hires) would decrease the employer contribution rate by 1.61 percent; increase the plan's funded status to 64 percent; and reduce first year employer contributions by $92.8 million.

Cost-of-living adjustment (COLA)

The cost-of-living adjustment is one of the costliest benefit provisions included in the PERS plan, accounting for an estimated 25 percent of the plan's payouts during a single year. The Study Commission recommended two provisions related to the cost-of-living adjustment, which is commonly referred to as the "13th check." This is due to the fact that some PERS beneficiaries choose to receive their cost-of-living adjustment as a one-time payment during the course of the year. The Study Commission did not recommend any changes to the current option to take the cost-of-living adjustment as a lump sum payment ("13th check").

The Study Commission recommended freezing the current cost-of-living for three years and thereafter tying the COLA to the Consumer Price Index with a cap of three percent. This means that current retirees would receive the same amount of their COLA as the last year; however, it would not increase for three years above its current amount. For individuals not yet receiving a COLA, this would mean that no COLA would be received for three years after retirement. A statutorily fixed cost-of-living adjustment does not provide a mechanism for ensuring COLA payments track inflation. For example, PERS beneficiaries received at least a nine percent (or higher) cost-of-living adjustment from 2008 to 2011. During this same time period, inflation rose half that amount – 4.54 percent – based on the latest Consumer Price Index data available.

Implementing these changes for future accruals of current members and retirees, as well as all new hires, would result in a reduction in contributions by 2.12 percent; an estimated funded status of 67 percent; and a reduction in first year employer contributions of $122.2 million.

Final average compensation

To help reduce abuses in the system, the Study Commission recommends the final average compensation of a PERS retiree should be based on four consecutive years of service based on the employee's base pay. The Legislature should study whether it is appropriate to include unused leave, overtime pay, special pay, and per diem and travel (in the case of legislators) as part of an individual's final average compensation.

The Study Commission also recommends that consideration be given to using full time equivalent compensation for covered members who are not full time (along with crediting partial years of service for benefit computations, but full years of service for eligibility) to help PERS manage the stacking of salaries.

The Study Commission recommends the Legislature review all statutes related to PERS and consider the implication of certain statutes that may allow for "spiking," stacking of salaries, or other manipulations within the PERS plan.

Analysis of costs

The Study Commission believes the Legislature should review employer practices that result in inequitable costs to the PERS system. Participating employers who offer early retirement incentives may shift compensation costs onto the plan. The Legislature should consider, among other things, an analysis of individual experience for PERS employers to determine what employers actually cost the system.

Legislative best practices

The Study Commission recommends that the Legislature require a fiscal note and one-year study period for legislation modifying PERS plan design before it can be considered for enactment. This one-year study period and fiscal analysis would afford legislators, members of the public, retirees, and current and future public employees an opportunity to fully understand the potential impact of new legislation to the PERS system, both in the short and long-terms.

Vesting period

The Study Commission recommends that the vesting period be lowered from eight years to four years. The Study Commission felt that it was important that workers be entitled to some retirement allowance after four years of service and that eight years was too lengthy of a period to work to become eligible for a benefit.

Supplemental Legislative Retirement Plan

The Study Commission recommends that the Legislature conduct a transparent review of whether it is appropriate to have an additional benefit for members of the Legislature and the President of the Senate, particularly when these individuals are also entitled to a normal PERS benefit.

Funding policy

The Study Commission notes that the GRS report suggests a more substantive funding policy for PERS, including a plan to reduce the amortization period, addressing a volatile investment environment, and addressing the allocation of risk and contributions between the employer and employee.

II. Creation of the PERS Study Commission

Governor Haley Barbour has called for changes to and study of the Public Employees' Retirement System (PERS) plan, including in his published Executive Budget Recommendations for Fiscal Years 2011 and 2012 which are provided to the Legislature. The Governor has publicly stated his belief that the long-term health of PERS is important to both beneficiaries and taxpayers and took action to push for review of the system.

Initially, the Governor through his board designee asked the PERS Board of Trustees to commission an independent review of the system. The Governor's appointee made a motion to commission an independent review of the system during a Board committee meeting on February 23, 2011; however, this motion failed 7 to 3. Subsequently, Governor Barbour proposed a bill during the 2011 legislative session to establish a PERS study committee. Senate Concurrent Resolution 678 was passed overwhelmingly by the Mississippi Senate, but the legislation died in the House of Representatives when SCR 678 was not considered for a vote.

On August 9, 2011, Governor Barbour issued Executive Order No. 1061 (see Appendix A-1), which created the Public Employees' Retirement System Study Commission to evaluate the state's retirement system and provide recommendations on ways to strengthen the system. Specifically, the commission was charged with making recommendations on improving the financial, management, and investment structure of PERS including:

- Analyzing the financial structure and funding mechanism of PERS, including an analysis of the ratio of taxpayer to employee contributions
- Analyzing the management structure of the agency, including the make up of the PERS Board of Trustees
- Analyzing the investment structure of PERS, including any comparison to similarly-sized funds, as well as larger funds, with respect to performance and fees charged
- Analyzing the legality of modifying the benefit structure for current and future state employees
- Analyzing any and all actuarial assumptions for the PERS plan
- Analyzing what experts have been engaged by PERS, what their responsibilities are, how much they are paid, and what benefits and services PERS receives from these experts
- Analyzing any other issue related to PERS that will help promote solvency and ensure the interests of taxpayers, state employees, and retired state employees are protected.

After the Public Employees' Retirement System Study Commission was created, much discussion regarding the need for such a group was generated. The goal of this document is to provide background information compiled by the Commission during its work as well as well as recommendations on ways to strengthen the state's retirement system.

III. Background on PERS

Section 25-11-101 of the Mississippi Code shows PERS was created in 1952 as an agency of state government for the purpose of providing retirement benefits for employees and beneficiaries. (For a description of PERS, see Appendix A-2.) The statute further requires the Legislature's Performance Evaluation and Expenditure Review (PEER) Committee to perform "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." However, since 2002 there have been no published reports on the state's retirement system conducted by the PEER Committee.

In 1985 and 1986, retirees promoted and the Legislature adopted an amendment to the Mississippi Constitution to protect PERS retirement funds. Section 272-A reads as follows:

> (1) All of the assets, proceeds or income of the Public Employees' Retirement System of Mississippi and the Mississippi Highway Safety Patrol Retirement System or any successor systems, and all contributions and payments made to the systems to provide for retirement and related benefits shall be held, invested as authorized by law, or disbursed as in trust for the exclusive purpose of providing for such benefits, refunds and administrative expenses under the management of the board of trustees of the systems, and shall not be encumbered for or diverted to any other purposes.
>
> (2) Legislation shall not be enacted increasing benefits under the Public Employees' Retirement System of Mississippi and the Mississippi Highway Safety Patrol Retirement System in any manner unless funds are available therefor, or unless concurrent provisions are made for funding any such increase in accordance with a prior certification of the cost by the board of trustees of the systems based on accepted actuarial standards.

Section 2 of this constitutional amendment expressly states that no retirement benefits shall be increased unless funds are available to cover the costs of these benefit enhancements. However, in 1999, a conference committee of the Mississippi Legislature inserted a slate of increased benefits into PERS related legislation. House Bill 472 was the vehicle for these unfunded changes which were "funded" by extending the amortization (payback) period of the retirement system – a funding practice which a 1998 PEER report warned the Legislature against adopting. In fact, the report recommended the Legislature should fund benefit enhancements by increasing contribution rates in order to maintain the integrity of the system.

Legislative Benefit Enhancements to PERS, 1999-2002

July 1, 1999

- Benefit accrual increased from 2% to 2-1/4% for all years of service over 25 for current and future retirees
- Base COLA increased to 3% simple up to age 55 and 3% compounded after age 55

July 1, 2000

- Benefit accrual increased from 1-7/8% to 2% for all years of service over 10 and less than 25 for current and future retirees

July 1, 2001

- Benefit accrual increased from 1-7/8% to 2% for all years of service over 5 and less than 25 for current and future retirees

July 1, 2002

- Benefit accrual increased from 1-7/8% to 2% for all years of service up to and including 25 and from 2-1/4% to 2-1/2% for all years of service over 25 for current and future retirees
- Increased maximum compensation cap to $150,000

In studying the background of these changes, it appears the Legislature passed large benefit increases because PERS' investment returns in the 1990s put the system in excellent financial shape, and the Legislature intended that existing retirees and employees should share in that largesse. Thus, the Legislature adopted these increased benefits to be phased in between 1999 and 2002, and made them retroactive not only for employees but also for retirees.

Information provided by PERS and conducted by their actuary, Cavanaugh MacDonald, shows that had the 1999 benefit enhancements not been implemented, the employer contribution rate could have been maintained at 9.75 percent and the amortization period would have been 26.5 years; if only the cost-of-living adjustment provisions had been implemented, the employer contribution rate would have needed to increase to 11.33 percent in order to keep the amortization period at 30 years. Currently, the employer contribution rate is 12 percent and will increase to 12.93 percent in January 2012. This rate is projected to increase to 14.26 percent in July 2012.

In 1998, high investment returns did push PERS' Unfunded Actuarial Accrued Liability (UAAL) down to $1.9 billion, which was 15 percent of assets and 56.4 percent of covered payroll. However, because of the unfunded benefit increases in 1999 and lower-than-anticipated investment returns going forward, the system's financial shape began to deteriorate. The adjacent chart shows what happened. By fiscal year-end 2011, UAAL topped $12.3 billion and was up to 37 percent of assets and 217 percent of covered payroll.

In 2011, Moody's Investor Service took note of Mississippi's "above-average debt ratios," citing rising PERS' unfunded liabilities as the major factor. Fitch Ratings made the following disclosure: "The funding of the state's Public Employees' Retirement System has declined in recent years, and the June 30, 2010 funded ratio was 64.2%. Using Fitch's more conservative 7% discount rate assumption, the system's funded ratio would be a weak 57.8%." Standard and Poors cited as a negative factor, "below-average funding of state pension plans." The views of these bodies may adversely affect the state's borrowing ability.

Mississippi PERS System Unfunded Liabilities

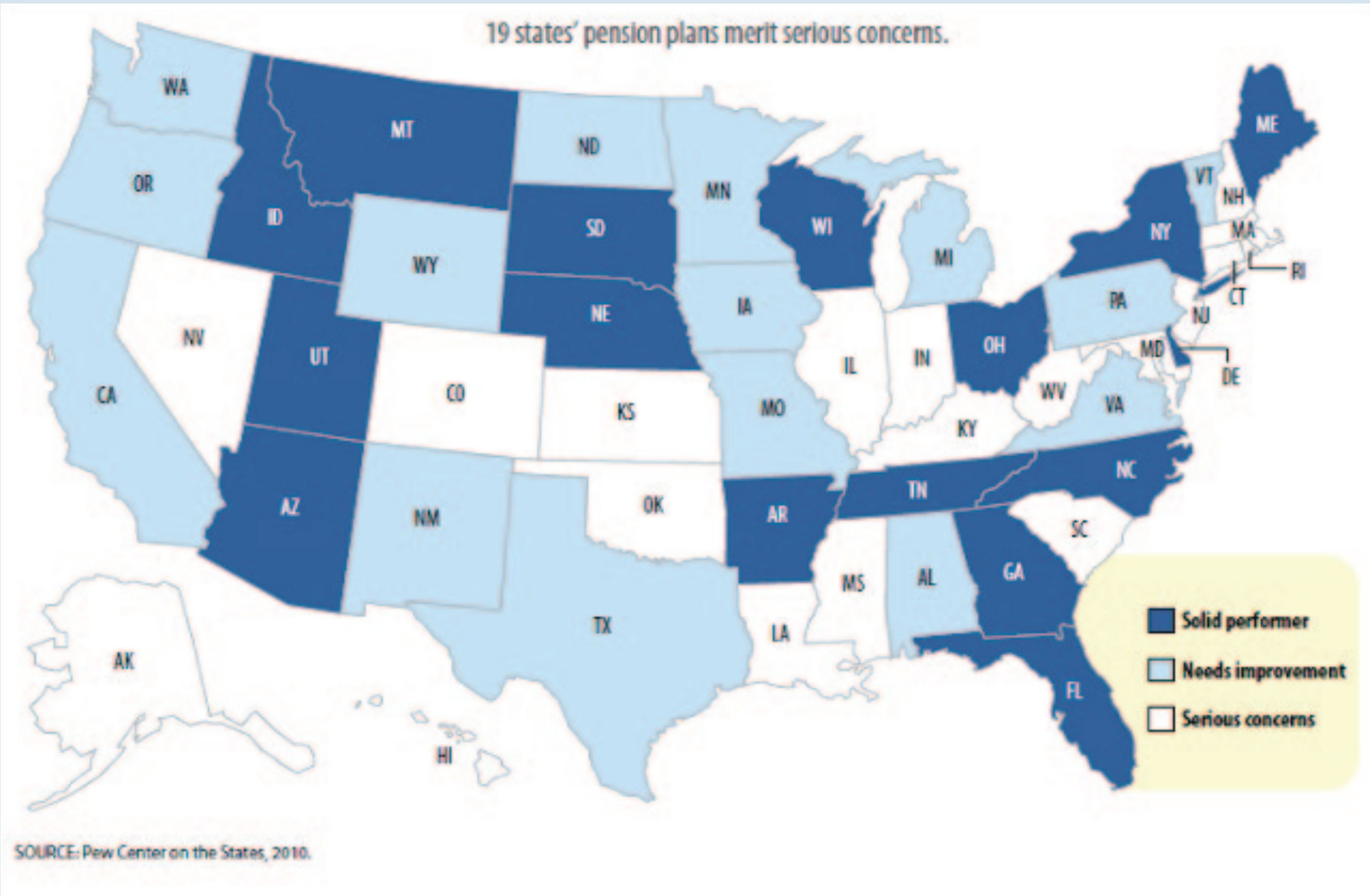
(in millions of dollars)		UAAL as	UAAL as
Fiscal Year	UAAL	% of Assets	% of Payroll
1998	$1,945,461	15.0 %	56.4%
1999	$2,734,729	17.4 %	73.7%
2000	$3,153,022	17.5 %	77.1%
2001	$2,302,576	12.5 %	56.0%
2002	$3,357,162	16.6 %	79.5%
2003	$4,506,381	21.0 %	101.7%
2004	$5,743,975	25.1 %	124.4%
2005	$6,546,393	27.6 %	136.8%
2006	$6,607,401	26.5 %	123.9%
2007	$7,071,072	26.3 %	136.1%
2008	$7,719,974	27.1 %	139.2%
2009	$9,996,965	32.7 %	171.4%
2010	$11,256,562	35.8 %	195.3%
2011	$12,339,300	37.8 %	217.1%

According to a survey conducted by Boston College's Center for Retirement Research, PERS ranks 94th of 124 public employee plans. Gabriel Roeder Smith & Company (GRS), which provided consultation services for this report, conducted a study of 78 retirement systems, which included a PERS ranking of 60th out of 78 plans based on its unfunded actuarially accrued liability status. This result confirmed the low ranking given PERS in the report "The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform" released by PEW Charitable Trusts in February 2010. Using 2008 data, PEW ranked PERS in the bottom 19 of the 50 states in the category labeled "serious concerns."

An excerpt from the PEW report describes the issue:

From 1999 to 2002, [the] Mississippi [Legislature] increased its pension benefits substantially without putting in place a funding mechanism. "A lot of people were riding that wave of euphoria from investment returns," said Pat Robertson, executive director of the Mississippi Public Employee Retirement System. Much of the increase in benefits came in the form of unfunded cost-of-living increases to retirees. Retirement formulas also were changed for current employees, effectively providing an unfunded retroactive benefit increase. [In] 1998, the Mississippi Public Employee Retirement System was about 85 percent funded, with full funding envisioned in a little less than 10 years. In 2008, the funding level had dropped to about 73 percent, with full funding now almost 30 years away. The actuarially required contribution vaulted from $362 million in 2000 to nearly $637 million in fiscal year 2008.

How Well Are States Managing Their Pension Obligations?



These costly (and unfunded) benefit enhancements took a toll on the pension plan. In 2001, near the time when the benefit increases were passed, PERS was financially strong with a funded status of 88 percent; a decade later, the funded status had declined to 62.4 percent, well below the 80 percent level most experts consider the minimum threshold for healthy plans.

Action to correct the system appears to have been slow. In 2006, the PERS Board began increasing taxpayer-funded employer contributions to slow the system's growth in unfunded liabilities. In 2007, the Legislature passed legislation to move vesting requirements from four to eight years, but analysis performed by GRS indicates this may not be a cost-savings to the system.

The increases in employer (taxpayer) contributions have been and will continue to be significant. The employer contribution rate increased from its steady 1990 to 2005 rate of 9.75 percent of payroll to 10.75 percent in fiscal year 2006, to 11.30 percent in 2007, 11.85 percent in 2008, and 12 percent in 2010. The rate was scheduled to rise to 13.56 percent in 2011. At Governor Barbour's request, the Legislature authorized an increase in employee contributions, which had remained level while taxpayer funded, employer rates increased. The employee rate increased from its steady 1991 to 2010 rate 7.25 percent to 9 percent in 2011. This represented an increase of 24 percent. After a one-year stay, employer rates will begin rising again in 2012, going up to 12.93 percent. PERS currently projects the employer rate to continue to rise, increasing to 14.26 percent in July 2012. That means the taxpayers' share will have been increased by almost half (46.2 percent) over the last eight years.

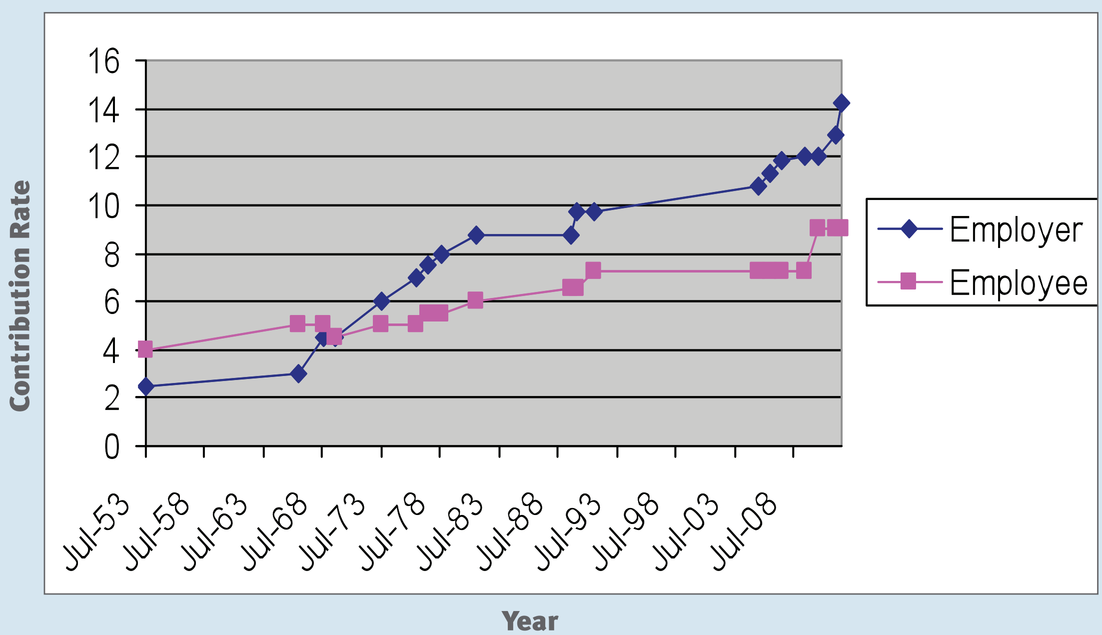
In July 2011, the PERS Board revised some if its regulatory provisions, including PERS Board Regulation 60. This regulation includes the following statement:

"Pursuant to Miss. Code Ann. § 25-11-123 (1972, as amended), the Board of Trustees of the Public Employees' Retirement System is authorized to set the contribution rates for both employee and employer contributions based on the basis of the liabilities of the retirement system as shown by the actuarial valuation."

Despite their statutory and regulatory authority, the PERS Board has stated no current plans to increase the employee contribution rate, even though this rate has only been increased once since 1991. The Board has contended that any increase in the employee contribution rate without an offsetting benefit enhancement violates an implied contractual right. Thus, despite increases on both taxpayers and employees, the taxpayers' share will go up two more times, totaling more than 18 percent, within a year.

In 2010, the PERS Board conducted its own review of the plan through an ad hoc study committee; the results of that study were provided to the PERS Study Commission. Additionally, the Legislature in its 2010 session made several changes to the system designed to rein in costs in the long-term, including tightening regulations on "double-dipping" into the PERS plan as well as increasing the number of years of creditable service required for retirement from 25 years to 30 years for new employees hired on or after July 1, 2011. In its 2011 session, the Legislature also approved PERS Board recommendations to reduce benefits for those retiring at age 60 with less than 30 years service, moving the 2.5 percent retirement multiplier out to 30 years from 25 years, and moving the 3 percent compound COLA rate from age 55 to age 60. These changes are applicable to employees hired on or after July 1, 2011.

PERS Contribution Rate Increases



PERS Funded Status History

Courtesy of PERS

Risk Factors

Systems that depend on investments to provide income for payments inherently include a certain amount of risk; however, the Study Commission felt that deeper analysis of PERS risk factors should be reviewed to understand the potential threats to the retirement system.

Investment Mix

The Public Fund Survey Summary of Findings for FY 2009, published by the National Association of State Retirement Administrators, showed the average asset allocations for public retirement plans was 60.8 percent equities (this number includes 8.7 percent in alternatives, which are mostly private equities and hedge funds), 29 percent fixed income, 5.9 percent real estate, and 4.4 percent cash and other.

As of September 30, 2011, PERS asset allocation was 65.6 percent equities (cumulative total for U.S., non-U.S., private, and global); 25.4 percent fixed income; 7.2 percent real estate; and 1.9 percent cash. PERS asset allocation and investment mix will be discussed further in the report.

Non-Investment Cash Flow

When retirement pay-outs to members exceed pay-ins by participating governmental bodies and employees, dependence on investment returns increases. Until Fiscal Year 2000, the sum of employer and employee contributions exceeded payments to retirees and refunds. As the chart below shows, despite the increases in contribution rates described above, the net payout has been growing since 2001. What this also shows is that increased contributions are not going to reduce the unfunded actuarially accrued liability (UAAL) but are going to fund increasing retirement costs. This puts more pressure on PERS to achieve projected investment returns.

Mississippi PERS Contributions VS Payments

(In millions of dollars)

YEAR	Employee Contributions	Employer Contributions	TOTAL CONTRIBUTIONS	Benefit Payments	Refunds	TOTAL PAYMENTS	NET
1999	$ 274,056	$ 372,661	$ 646,717	$ 562,191	$ 49,283	$ 611,474	$ 35,243
2000	$ 301,885	$ 407,595	$ 709,480	$ 612,644	$ 58,817	$ 671,461	$ 38,019
2001	$ 310,257	$ 418,281	$ 728,538	$ 759,282	$ 65,370	$ 824,652	$ (96,114)
2002	$ 317,563	$ 428,122	$ 745,685	$ 847,655	$ 62,126	$ 909,781	$ (164,096)
2003	$ 333,297	$ 448,263	$ 781,560	$ 951,158	$ 61,923	$ 1,013,081	$ (231,521)
2004	$ 358,241	$ 459,567	$ 817,808	$ 1,033,205	$ 67,245	$ 1,100,450	$ (282,642)
2005	$ 365,355	$ 492,434	$ 857,789	$ 1,116,405	$ 71,064	$ 1,187,469	$ (329,680)
2006	$ 375,612	$ 557,831	$ 933,443	$ 1,198,230	$ 73,344	$ 1,271,574	$ (338,131)
2007	$ 392,268	$ 610,888	$ 1,003,156	$ 1,291,456	$ 72,572	$ 1,364,028	$ (360,872)
2008	$ 417,119	$ 683,189	$ 1,100,308	$ 1,393,175	$ 72,750	$ 1,465,925	$ (365,617)
2009	$ 434,081	$ 713,569	$ 1,147,650	$ 1,465,500	$ 70,050	$ 1,535,550	$ (387,900)
2010	$ 439,397	$ 731,544	$ 1,170,941	$ 1,580,808	$ 73,580	$ 1,654,388	$ (483,447)

Projected Investment Returns

PERS projects an eight percent investment return over the life of the plan. But, for the past ten years, investment returns have averaged less than six percent. Each year the PERS actuary performs an experience review. This August, Cavanaugh MacDonald recommended that PERS lower its projected eight percent return to 7.5 percent. The report suggested the change because "there is a less than 50% chance that the net return will be 7.50% or more over a 50-year period. The current net return of 8.00% is at the 63rd percentile... Since the 50th percentile is much lower than 8.00%, we recommend PERS consider lowering the investment return assumption from 8.00% to 7.50%."

The ranking of investment return by percentile shows the likelihood or unlikelihood of attaining a particular return. For example, a return above 50 percent means that it is more likely than not that the expected return will not be achieved. Thus, a more conservative view would place the expected return at or below the 50 percent ranking.

PERS chose to retain the eight percent assumption and increase its risks. Lowering the investment return assumption to 7.5 percent would require a substantial increase in contribution rates for employers and possibly employees. Further discussion of the investment return assumption will be covered later in this report.

Open-ended Unfunded Actuarially Accrued Liability (UAAL) Amortization Period

PERS is required to amortize its $12.3 billion UAAL like a loan. The maximum loan period is 30 years, like a home mortgage. PERS first started raising employer contribution rates with the goal of reducing the UAAL mortgage to less than 30 years. As the UAAL has grown, PERS has had to stick with the maximum 30-year mortgage, meaning that each year PERS has refinanced its mortgage payments. If the full UAAL were to be paid off in 30 years, employer contributions, once again, would increase substantially. In other words, the state's retirement plan is not chipping away at its unfunded liability status. Instead, PERS has an unending 30-year mortgage with payments that may be artificially low.

PERS is at the maximum allowable amortization period. If periods of anemic returns or negative returns occur, the system has no choice but to substantially increase contribution rates since it cannot extend the amortization period. (While the open-ended UAAL amortization period is allowed, new Governmental Accounting Standards Board requirements are reviewing this practice. More information regarding GASB requirements is discussed later in this report.)

Wage Inflation Assumption

Retirement plans must take into account the assumed future increases in salaries, which consist of both an inflation component and a component for promotion and longevity. The inflation component is the wage inflation measure. PERS currently uses a 4.25 percent assumption, which was questioned by GRS in its 2010 audit of the PERS plan. This assumption is based on national figures and is not specific to Mississippi.

Further, it may be high given today's economic climate, with hiring freezes and legislatively-prohibited salary increases for public employees.

The Commission notes the following GRS 2010 audit language: "However, we find it unusual that the wage inflation assumption was increased from 4.00% to 4.25%. This is particularly perplexing given the pressures on governments to downsize and the reduced revenue available to pay salaries that were evident while the study was being produced. We recommend that the Actuary and Board revisit this assumption and consider the constraints that governments are facing to determine if this assumption should be lowered."

IV. Other States and Systems

Mississippi is not alone in facing financial challenges related to pensions in the foreseeable future. In fact, most states have begun grappling with similar pension issues in their own states.

The U.S. Census Bureau released financial information regarding public employee retirement systems, finding that the nation's "state and local public employee retirement systems had $2.5 trillion in total cash and investment holdings in 2009, a $726.1 billion or 22.7 percent decrease from $3.2 trillion in 2008. This follows a $176.7 billion loss the previous year." The PEW Center on the States has previously estimated that states collectively had an unfunded gap of $1 trillion to pay pension, healthcare, and other post-retirement benefits. In their initial report issued February 2010, the Pew Center explained that while "recent investment losses can account for a portion of the growing funding gap, many states fell behind on their payments to cover the cost of promised benefits even before the Great Recession. Our analysis found that many states shortchanged their pension plans in both good times and bad, and only a handful have set aside any meaningful funding for retiree health care and other non-pension benefits."

The report continued that "in the midst of a severe budget crisis—with record-setting revenue declines, high unemployment, rising health care costs and fragile housing markets—state policy makers may be tempted to ignore this challenge. But they would do so at their peril. In many states, the bill for public sector retirement benefits already threatens strained budgets. It will continue to rise significantly if states do not bring down costs or set aside enough money to pay for them."

Because of these factors, many states have already taken action to address pension issues. According to the National Conference on State Legislatures, pension reforms are occurring nationwide, with 27 states tackling the issue of pensions in 2011 and 21 states reviewing retirement policies in 2010. "Since some states revisited the topic," summarized the NCSL, "in all, 40 states enacted significant revisions to at least one state retirement plan in 2010 or 2011."

Among these changes included 16 legislatures increasing employee contribution requirements in 2011 (compared with 11 states in 2010), with most 2011 increases applying to current employees. The NCSL found that these "changes are a shift toward equalization of employee and employer retirement contributions, and testimony to continuing pressure on state budgets."

Fifteen legislatures increased age and service requirements for normal retirement for state employees, teachers or both groups of employees. In 2011, six legislatures lengthened the period over which final average salary is averaged to provide the base on which pension benefits are calculated (eight states made similar changes in 2010). Of particular note are the changes to cost-of-living adjustments. In 2011, ten states revised their provisions for automatic cost-of-living adjustments, as eight other states had done in 2010, according to NCSL.

Of particular note is Rhode Island, where the governor and legislature recently implemented a major overhaul of the state's pension system. Before the changes, Rhode Island's liability was estimated at $7 billion; after the changes are implemented, that number is reduced to $4 billion according to the Rhode Island Governor's Office. Without these reforms, Rhode Island would have had to pour more taxpayer money into its pension system – from $319 million in 2011 to $765 million in 2015 and $1.3 billion in 2028.

The Rhode Island pension system covers active and retired public teachers, state employees, judges and many municipal workers, and 58 percent of retired teachers and 48 percent of retired state workers receive more money in their pensions than they did while working for the state, according to reporting by National Public Radio. The new legislation would suspend automatic annual pension increases for retirees for five years and then only award these increases if investments performed well. The Rhode Island legislation also raised the retirement age for many workers as well as created a hybrid benefit plan that mixes pensions with a 401(k)-style account, also known as a defined contribution plan. Gina Raimondo, Rhode Island's State Treasurer who campaigned on pension reform, pushed the legislation. According to Raimondo, fixing "the state's pension system will require direct and honest dialogue with the understanding that sacrifices will be expected by everyone....It can also not be ignored that there are hard-working Rhode Islanders outside the pension system, who are also struggling to save for their own retirements in the face of rising taxes – taxes that go to support the retirement system."

Even on the municipal level, mayors are dealing with pension reform. Atlanta Mayor Kasim Reed addressed the city's pension crisis head-on, according to a report by Governing Magazine's November 2011 edition. Atlanta's retirement plan had "plummeted from 99 percent funded in 2001 to 51 percent funded by 2009 – a $1.5 billion problem." Mayor Reed overhauled the city's pension system, passing reforms that impacted new hires as well as existing employees, shifting from a defined benefit plan to a defined-contribution plan and increasing workers' contributions by 5 percent. According to the article, these and other fiscal reforms put the "city on its soundest fiscal footing in a generation...Reed is a Democrat, but his pragmatic, bipartisan approach – which he attributes to his 11 years in the state Legislature – has earned accolades from leaders on both sides of the aisle."

V. PERS Study Commission Structure

Members and Consultants

The PERS Study Commission included representation from the private and public sector. Retired Hancock Bank Chief Executive Officer and current Gulfport Mayor George Schloegel served as chairman of the commission. Joining Mayor Schloegel was a wide array of business leaders and those with expertise in pension issues, including Will Flatt of Parkway Properties; former Supreme Court Justice Reuben Anderson; Harry Walker of Trustmark Bank; Seale Pylate of Phelps Dunbar; Bill Crawford, former legislator, PERS retiree, and president of The Montgomery Institute; Bill Benson, Lee County Chancery Clerk and current chairman of the PERS Board of Trustees; and Kevin Upchurch, Department of Finance and Administration Director. Legislators who are non-voting members of the commission include: Sen. Hob Bryan, Sen. Dean Kirby, Rep. Preston Sullivan and Rep. Greg Snowden.

Due to the complicated nature of the state's pension plan, the Governor's Office on behalf of the Study Commission engaged the services of professional actuaries from Gabriel Roeder Smith & Company (GRS), one of the largest public sector actuarial services firms in the nation. These services were acquired after a competitive Request for Proposals process was conducted by the Governor's Office in consultation with the PERS Study Commission.

Public Engagement

Upon its formation, the PERS Study Commission recognized the need to engage the public in its discussions. Each PERS Study Commission was open to members of the general public and news media, and information regarding the activity of the commission was disseminated through an updated webpage accessed by visiting **www.governorbarbour.com** and clicking "PERS Study Commission." Press releases were sent regarding PERS Study Commission activity, and the commission established an email address and comment form to solicit comments and questions. More than 670 emails were sent to **retirementstudy@governor.state.ms.us**; more than 1,500 letters were also received. To further enlist public participation, the PERS Study Commission held a public comment opportunity on Sept. 14, 2011, at the Mississippi State Capitol. The hearing was announced statewide and provided a venue for the public to provide input regarding the state's retirement system. Members of the public also commented and asked questions during most meetings of the Study Commission.

The public comment hearing was attended by more than 100 individuals, including legislators, retirees, current state employees, interest groups, members of the media and members of the general public. The commission heard from 15 speakers at the hearing, including Philene Allen, Mississippi Professional Educators; Chip Denton, CEO of Grenada Lake Medical Center; Brenda Scott, Mississippi Alliance of State Employees/CWA; Carolyn Smith, president of the Retired Education Personnel of Mississippi; Kay Sims, Mississippi Gulf Coast Community College; Ann Thames, former employee at the Mississippi Department of Mental Health; Dwight Luckett, Canton School District; Dr. Phillip Burchfield, Clinton Public School District; Kay Clay, retired superintendent; Kevin Gilbert, Mississippi Association of Educators; Rob Martin, Mississippi Fire Chiefs Association president; Tim Medley, Medley & Brown Financial Advisors; Sam Valentine, Mississippi Retired Public Employees Association president; Jameson Taylor, Mississippi Center for Public Policy; and Mary Perry, Meridian Councilwoman.

Structure of Commission and Work

The PERS Study Commission was divided into three subcommittees, which included investment and finance (Harry Walker, chairman); management (Bill Crawford, chairman); and legal (Seale Pylate, chairwoman). Each subcommittee was given specifics areas to review, with recommendations presented to the full commission for consideration. Additionally, the full commission voted on retirement policy recommendations which are included in the next chapter.

VI. Subcommittee Reports

Investment and Finance

Harry Walker, chair of the investment and finance subcommittee, presented recommendations to the full commission. Three recommendations and one informational item were approved by the full commission for inclusion in this report.

Investment Return Assumption

PERS currently assumes an 8 percent investment return. According to PERS "Facts and Figures" document, PERS has achieved the following investment returns:

Investment Rates of Return

1-year• 25.40%
3-year• 4.85%
5-year• 4.70%
10-year• 5.41%
20-year• 8.09%
30-year• 9.91%

PERS actuary Cavanaugh MacDonald recommended to the PERS Board of Trustees in August 2011 that PERS should lower its assumed rate of return from 8 percent to 7.5 percent.

Investment Performance

Courtesy of PERS

According to the report, the financial impact of this adjustment would include:

- A change in the unfunded accrued liability from $11.2 billion to $12.9 billion
- A change in the funding ratio from 64.2 percent to 61 percent
- A change in the annual required contribution from 12.93 percent to 15.29 percent

According to Cavanaugh MacDonald's report, the investment return assumption is built on two measures: the assumed price inflation and the real rate of return. PERS currently assumes a 3.5 percent price inflation measure. "Although the 10-year average of 2.4% is significantly lower than Mississippi's assumed rate of 3.50%, the longer 40 and 50-years averages of 4.4% and 4.1% respectively, are all higher than Mississippi's rate," concludes the Cavanaugh MacDonald report. The actuarial firm adds that the validity of Mississippi's assumption is, therefore, dependent upon the emphasis one assigns to the short and long-terms. Cavanaugh MacDonald recommends keeping the 3.5 percent assumption as it falls within their 2 to 4 percent reasonable assumption range.

The other measure used for developing an investment return assumption is the real rate of return, which is currently 4.5 percent (price inflation at 3.5 percent plus real rate of return assumption at 4.5 percent equals the current 8 percent return assumption). Cavanaugh MacDonald notes that the "assumed investment return is one of the most significant assumptions in the annual actuarial valuation process" and "minor changes in this assumption can have a major impact on valuation results."

The Cavanaugh MacDonald report found that the target asset portfolio for PERS "seems to have shifted to a more conservative balance between equities and fixed income at the same time that the capital market assumptions have shifted to lower expected returns for all asset classes" resulting in a "significantly lower return" for PERS investments. Even though the 8 percent investment return assumption currently used by PERS falls within Cavanaugh MacDonald's "reasonable range" of returns (6.09-8.62 percent) Cavanaugh MacDonald recommends that PERS lower its investment return assumption from 8 percent to 7.5 percent.

Other states have reduced their investment return assumptions according to information provided by GRS and other sources. According to an October 2011 National Association of State Retirement Administrators (NASRA) Issue Brief ("Public Pension Plan Investment Returns"), 8 percent remains the predominant rate assumption but states have recently lowered their investment return rates. Of the 126 plans in the NASRA survey, 19 had reduced their investment return assumption since Fiscal Year 2008; since Fiscal Year 2001, 44 plans had reduced their rate.

GRS provided the Study Commission with a chart of information regarding states that have recently lowered their return assumptions in years 2010 or 2011.

States that have Lowered their Return Assumptions in Years 2010 or 2011

Retirement System	Prior Assumption	Current Assumption
Arizona PS*	8.50%	8.25%
California STRS	8.00%	7.75%
Colorado PERA	8.50%	8.00%
Colorado FPPA	8.00%	7.75%
Detroit Police and Fire RS	7.50%	8.00%
District of Columbia RB	7.50%	7.00%
Hawaii ERS	8.00%	7.75%
Illinois SERS	8.50%	7.50%
Illinois SURS	8.50%	7.50%
Indiana PERF	7.25%	7.00%
Indiana TRS	7.50%	7.00%
Missouri LAGERS	7.50%	7.25%
New Hampshire Retirement System	8.50%	7.75%
NY State and Local ERS	8.00%	7.50%
Ohio SERS	8.00%	7.75%
Pennsylvania PSRS	8.25%	8.00%
Pennsylvania SERS*	8.50%	8.00%
Rhode Island ERS	8.25%	7.50%
San Francisco City and County	8.00%	7.75%
Virginia Retirement System	7.50%	7.00%
Wisconsin Retirement System	7.80%	7.20%

Investment Assumption Changes in 2010 or 2011
(unless indicated otherwise)
**AZ may go to 8% next year, but requires another Board vote*
**PA: These represent 2009 figures.*

After considering these factors, the PERS Study Commission voted to recommend that the PERS Board re-consider lowering its investment return assumption to 7.5 percent as recommended by Cavanaugh MacDonald.

Investment Policy

According to the PERS Strategic Asset Allocation Policy adopted June 2010:

[T]he primary method utilized in achieving the return objectives for PERS is the allocation of assets. The Board adopts an asset allocation policy as the framework to insure the assets are invested in a prudently managed and well diversified portfolio designed to meet the established return targets. The strategic target allocation below is intended to accomplish the Board's objectives over time. In addition to the target allocations the Board has established target ranges for the each asset class. These ranges provide the Board and staff the latitude to exercise management discretion in a tactical manner as appropriate.

According to the Public Fund Survey Summary of Findings for FY 2009, fixed income allocation for retirement plans has barely changed over the period of Fiscal Year 2002 through 2009, but increased allocations to real estate and alternatives have occurred by reducing equity allocations. This demonstrates an effort by most public funds to retain expected returns at lower levels of risk (or to increase projected returns at the same level of expected portfolio risk). Based on the following chart provided by PERS which demonstrates the system's asset allocation policies from a historical perspective (1983-2010), it appears that PERS asset allocation policies are mostly aligned with this trend.

PERS Asset Allocation Policies 1983-2010

Courtesy of PERS

Upon review and consideration of these factors, the Study Commission recommends that the PERS Board of Trustees more regularly review its investment policy to ensure the investment goals and strategy reflects current market conditions. An analysis of the PERS investment policy should be conducted in consultation with one or more expert financial consultants who can advise the Board of Trustees on matters including the "new normal" following the economic recession and ways to ensure that anticipated market conditions are reflected within the PERS investment strategy. These reviews should occur at least once every two years.

Defined Contribution and Hybrid Retirement Plans

While the Study Commission felt there was not enough time to adequately study the feasibility of the integration of a defined contribution feature in the overall retirement program, the Study Commission felt continued analysis should be conducted. Accordingly, PERS and/or the Legislature should evaluate structural changes, including automatic enrollment in the state's 457(b), a hybrid plan, or adding a separate defined contribution plan. Such a change could be an inducement to new hires by adding portability.

One way the PERS Board could further study this issue is by broadening the scope of its Defined Contribution committee to include a thorough review of whether Mississippi public employees would benefit from more retirement plan options. To achieve this goal, the PERS Defined Contribution committee could hire a consultant to run comprehensive analyses, including costs associated with the creation of another defined contribution plan option or a hybrid option for the PERS plan. Likewise, the Legislature could also study defined contribution and/or hybrid retirement plans by establishing its own study committee.

The Commission notes, however, that a report from the National Institute on Retirement Security ("A Better Bang for the Buck: Economic Efficiencies of Defined Benefit Plans") shows that defined benefit plans typically provide a more cost effective benefit. The report concludes, "[s]pecifically our analysis indicates that the cost to deliver the same level of retirement income to a group of employees is 46% lower in a DB plan than it is in a DC plan."

Additional information regarding hybrid plans may be found in the appendix (see Appendix A-3).

GASB Requirements and Impact on Mississippi PERS

The Study Commission felt that any thorough discussion of Mississippi PERS should include the potential impact of new Governmental Accounting Standards Board requirements regarding pension plan liabilities and other reporting issues. The changes are aimed to provide more clarity in reporting public pension liabilities. Compliance with the GASB rules is important to the state's credit rating and borrowing ability.

The Governmental Accounting Standards Board (GASB) is the independent organization that establishes and improves standards of accounting and financial reporting for U.S. state and local governments. Established in 1984 by agreement of the Financial Accounting Foundation (FAF) and 10 national associations of state and local government officials, the GASB is recognized by governments, the accounting industry, and the capital markets as the official source of generally accepted accounting principles (GAAP) for state and local governments.

A July 2011 report from GRS Insight, "The GASB's Exposure Drafts on Pension Accounting and Financial Reporting," discusses these proposed changes in full detail. The next page includes a detailed chart to better demonstrate some of the impacts of these new proposals *(see Appendix A-4 for full report)*.

The GASB has issued exposure drafts which, if they are adopted, will "significantly change pension accounting and financial reporting for state and local governments," according to the GRS Insight report. These changes include:

- Disconnecting state and local governmental pension accounting measures from the funding measures used to determine pension contributions;
- Requiring employers to recognize an unfunded pension obligation (i.e., the "net pension liability") as a balance sheet liability in their basic financial statements based on the market value of assets;
- Requiring employers to recognize a new measure of the pension expense in their basic financial statements that may have no relation to the actuarially determined contribution; and
- Replacing most of the current note disclosures and required supplementary information with information based on the new measures and removing disclosures showing the actuarial funded status of the benefits.

PERS participated in GASB's Field Test related to the new proposals. While further review of the impact to PERS is needed, the Study Commission concurs that PERS will need additional funding to comply with the GASB requirements if they are finalized in the current form.

Summary of Current GASB Pension Standards for Governmental Employers Compared with Proposed Changes Presented in the GASB's Exposure Drafts

Management

Bill Crawford, chair of the management subcommittee, presented recommendations to the full commission. Four recommendations were approved by the full commission for inclusion in the report.

Review the need for a periodic, professional, independent risk and operational review of the PERS plan

"Most members of the public do not have a basis upon which to critically examine these systems because of their complexities," reports the Public Plans Practices Task Force of the American Academy of Actuaries. "Therefore, taxpayers are not able to objectively evaluate how they are managed. They rely on their 'agents' – elected officials and public sector employers to make wise decisions on their behalf."

Cities, counties, school districts, community colleges, and other organizations participate in PERS along with state entities. The PERS Board has the power and responsibility to set contribution rates for each of these sponsoring employers.

"Today, there is, in many cases, a lack of aligned stakeholder incentives and a lack of reliable risk information for the stakeholders and their agents," the task force said.

The Task Force recommended that "the governing body must ensure that the contributions it receives from employees and sponsoring employer(s) represent a fair contribution for benefits earned during that period" and "that benefits are provided on a cost-efficient basis."

With eight of the ten members of the PERS Board representing employees and retirees, there is a perceived bias in favor of beneficiaries rather than non-participant taxpayers. In such cases, to ensure the credibility of the system, best practices recommend independent professional reviews of plan risks and performance.

The Study Commission recommends the Legislature should authorize and provide resources for the State Auditor to conduct regular, independent reviews of PERS plan risks and performance. Such reviews should occur at least every four years and any time the Legislature will consider changes to plan benefits. The State Auditor should report findings not only to the Legislature, but also to PERS, sponsoring employers, and the general public.

This review should be in addition to any review that may be conducted by the PEER Committee or other agent of the Legislature. The Legislature should consider forming permanent committees to oversee PERS with professional staff knowledgeable of actuarial science and retirement plan requirements and resources to hire independent actuaries.

This will address a fundamental issue with the system: clearly assign responsibility for the system. Responsibility for PERS has been a frequently recurring topic at the Commission's meetings. The Board of Trustees takes the position that its duties are ministerial in nature. While it is true that a defined body should be responsible for pursuing the day-to-day administration of PERS, it is also true that the responsibility for the substance of PERS rests with the Legislature. As such, it must take ownership of the plan and supervise any entity to which it delegates responsibility.

Analyze the management structure of the agency, including the make-up of the PERS Board of Trustees

The management structure of the PERS agency is consistent with the structure in most states – a board of directors that hires an executive director to manage operations. The make-up of retirement system boards, however, varies from state to state.

The Government Finance Officers Association (GFOA) recommends that "board composition should reflect the varied interests of those responsible for funding the plan and should include plan participants and retirees, citizens of the governmental unit, and officers of the plan sponsor, as well as independent directors. This assures balanced deliberations and decision making."

The PERS Board includes ten members, six elected by public employees, two elected by retirees, one appointed by the Governor, and the State Treasurer. Eight of the ten members represent plan participants and retirees and two, the Governor's appointee and the State treasurer, represent the plan sponsor, the State of Mississippi. None represent non-participant citizens, and none are independent directors.

Some states also require some of the board members to have substantive knowledge about investments and/or financial management. For example, Kentucky requires its Governor to appoint two members with at least ten years of investment experience. Mississippi has no such requirement.

After reviewing these factors, the PERS Study Commission recommends the Mississippi Legislature should take heed of the "best practice" recommended by the Government Finance Officers Association regarding the balanced representation on retirement boards such as the PERS Board. There are several ways to approach this.

Option 1: The Legislature should add additional independent members to the PERS Board with senior investment or financial management experience or extensive, senior-level private sector management experience and no direct or indirect interests in the plan.

Option 2: The Legislature could revise the positions currently held by the State Treasurer and appointed by the Governor by requiring the Governor and State Treasurer to appoint independent members with senior investment or financial management experience or extensive, senior level private sector management experience and no direct or indirect interests in the plan. This would give voice to taxpayers even though it would not balance board membership. If this option is selected it should be coupled with the previous recommendation by the Study Commission to engage an annual review by the State Auditor of the PERS plan.

Option 3: Some states establish independent commissions to administer retirement plan design. The Legislature could form a six-member commission with the Governor, Lieutenant Governor, and/or Speaker of the House appointing three members, each with senior investment or financial management experience or extensive, senior level private sector management experience and no direct or indirect interests in the plan. The PERS Board would select three of its members to serve on the commission. This commission would then assume authority over plan design, inputs, and assumptions used by the plan actuary. Plan operations and implementation along with other ministerial functions would remain under the PERS Board.

The PERS Board Chairman voted against Option 1 as listed above. In his objection, the PERS Board chairman noted for the record that he, as a member of the board of trustees, "was not a representative of the taxpayers" but was a "trustee representing the beneficiaries." He further stated that trustees are elected to represent only beneficiaries and, as such, he would not support "any changes to the PERS Board."

The Study Commission notes that the PERS Board has changed numerous times over the years, until its most recent iteration in 1993. Through the 1970s and until a change in 1989, the Legislature required the Board to have one member who was not a participant and who had at least ten years of investment banking experience.

Analyze what experts have been engaged by PERS, what their responsibilities are, how much they are paid, and what benefits and services PERS receives from these experts

In Fiscal Year 2009, PERS paid 35 investment managers $35.2 million to manage $18.8 billion in assets. In Fiscal Year 2010, PERS paid 37 investment managers $44.7 million to manage $21.9 billion in assets. The average cost per manager increased from $1 million to $1.3 million during that period and the number of managers increased 23 percent.

These costs do not require authorization through an appropriations bill approved by the Legislature.

	PERS Fiscal Year Rates of Return	Public Pension Funds > $1 billion Peer Universe Ranking
2011	25.4%	10
2010	14.1%	39
2009	-19.4%	54
2008	-8.2%	98
2007	18.9%	32
2006	10.7%	74
2005	9.8%	61
2004	14.6%	74
2003	3.5%	68
2002	-6.6%	76
2001	-7.1%	79

The success of investment managers hired by PERS has varied significantly. For Fiscal Year 2011, investment returns ranked in the top 10 percent for pension funds greater than $1 billion. Over the long-term, investment returns ranked in the top 60 percent only three times since 2001.

In Fiscal Year 2009, PERS hired professional service firms in 11 areas for $1.95 million. In Fiscal Year 2010, PERS hired professional service firms in 10 areas for $1.69 million. In Fiscal Year 2011, PERS hired professional service firms in 10 areas for $1.9 million.

Voting services and audit costs have escalated significantly over the last three years. The actuary costs in 2011 include an outside evaluation not incurred in 2010 or 2009. These costs are appropriated by the Legislature.

PERS Professional Service Fee Schedule

(In thousands of dollars)	2011	2010	2009
Fund evaluation	557	510	511
Actuaries	348	268	249
Medical fees	319	268	269
Legal-State of Mississippi Attorney General	211	254	200
Audit - Mississippi Office of the State Auditor, KPMG LLP	157	124	118
Voting services	135	104	81
System development consultant	76	20	159
Legal - outside	41	87	216
Graphic design	31	33	31
Reorganization			63
Mailing Services	26	21	49
Total	**1901**	**1689**	**1946**

Review the authority to "self-appropriate" and advise whether the PERS Board should seek an appropriation from the Legislature to cover costs or should be empowered with broader authority to impact management of the fund. For example, what authority should the board, executive director, or others have to adjust benefits, COLAs, employee contributions, etc., to keep the plan adequately funded as best practices from other states suggest?

Authority to Self-Appropriate

Through 1991, the Legislature's Performance Evaluation and Expenditure Review Committee (PEER) regularly assessed PERS performance and commented on PERS' failure, in some cases, to receive legislative approval for expenditures. The January 22, 1991, report (#273) states: "PERS has implemented nearly all recommendations contained in PEER's 1990 report, with few exceptions. It has failed to seek a legislative appropriation to authorize its expenditures for investment managers' fees, relying on an outdated Attorney General's opinion which holds that the system is a private corporation."

Notes to the PERS annual financial statement show this continues to be the case. Note (d) under Summary of Significant Accounting Policies states that annual budgets are legally adopted for the "administrative expenditure portion" of the pension trust funds. A budget for administrative expenditures is submitted to the Legislature which adopts a final budget in the form of an appropriation bill as provided in Section 25-11-123 of the Mississippi Code.

PERS, however, does not account for managers' fees and trading costs and other investment related fees as administrative expenses. These are accounted for as a cost of doing business under "net investment income" or as adjustments to "net assets" and are not submitted to the Legislature for an appropriation. Section 25-11-145 of the Mississippi Code provides that "investment management fees and costs shall be paid from the fund."

In Fiscal Year 2010, administrative fees amounted to $11.7 million. Manager's fees and trading costs and other investment related fees amount to amounted to $46.6 million.

Broader Authority

The PERS Board has authority to raise the contribution rates of sponsoring employers. The Legislature has also provided the PERS Board with statutory authority to adjust employee contributions biennially, an authority which is also reflected in PERS Board Regulation 60. The Board also has authority to administer the retirement program and to invest contributed and earned funds within limits set by state statute.

The PERS Board does not have authority to adjust benefits, vesting, COLAs, or other factors that impact the payout of funds. The authority for such factors remains vested in the Legislature.

Review the need for comprehensive risk management system under the board

The Public Plans Practices Task Force of the American Academy of Actuaries reviewed investment, operational, and governance risks associated with public retirement plans. The task force recommended that public plans implement risk assessment practices based on the following three observations:

1. Risks of public pension plans must be understood and managed better.
2. A risk evaluation, management and reporting framework is needed to identify and manage those risks.
   In particular it should:
   a. Identify moral hazards in the structural incentives for stakeholders and agents.
   b. Inform decision-makers of the risk levels and potential range of consequences inherent in current and proposed benefits, investments and governance structures.
   c. Identify possible stresses/breakdowns that could occur in the future and action steps that will be followed should they occur.
3. Actuaries will be integral to the application of such a framework to public pension plans.
   Areas of concern cited by the task force include:
   - Insufficient funding by legislative bodies.
   - Excessive benefit levels in relation to the risk capacity of the plan sponsor to fund them.
   - Inappropriate benefit designs.

The task force recommended that public plan risk management systems include the following:

- establish boundaries of risk taking;
- establish policies and mechanisms to support the following priorities:
  * fund continuously
  * educate administration and employees (including unions) to better understand the risk of current benefit structures
  * develop processes for identifying plan provisions that create misaligned and/or mispriced risk incentives for plan participants and sponsors
  * identify stakeholder incentives that clash with the health of the system as a whole.

Upon considering this information, the study commission recommends that the PERS Board implement a comprehensive risk management system that is compliant with the framework set forth by the Public Plans Practices Task Force of the American Academy of Actuaries. Risk factors should be listed, assessed and published in the PERS annual report. External and independent auditors should review and report on the adequacy of the risk management system. Reports on such a system should be provided to the Legislature.

Analyze the statute related to PERS providing health care to retirees once a certain funding level is reached

The Mississippi Legislature enacted legislation requiring the PERS Board to establish and fund a health care plan for retirees when the PERS plan reaches a certain funding level. The effect of this legislation would be to deplete assets intended for retirement in order to pay for retiree health insurance based on a temporary condition. It would also duplicate the state health insurance plan that already exists and is administered by the State and School Employees Health Insurance Management Board. The PERS Board has recommended that this legislation be repealed.

Retirement assets should be held exclusively by PERS to pay retirement benefits to members. Therefore, as recommended by the PERS Board, the study commission concurs that the Legislature should repeal Section 25-11-143 of the Mississippi Code.

Legal

The legal subcommittee provided the following report, which was accepted in full by the Study Commission.

The legal subcommittee was charged with reviewing the legitimacy of modifying the benefit structure of PERS for new hires, current employees, and retirees. The subcommittee was also charged with reviewing the provision of disability benefits through the system.

The subcommittee notes at the outset that the ultimate determination of the legality of any changes to PERS will rest with the state judicial system. This report is solely intended to set forth the subcommittee's analysis of the issues and to limit the scope of any recommendations by the full committee to items that have a likelihood of approval by a court[1].

The issue of modifications to governmental[2] retirement plans has been reviewed by the courts in many states, but no definitive decision has been issued by a Mississippi court. Certain changes to the benefit structure of the system, primarily related to the employee contribution rate, have been the subject of recent advisory and other opinions in Mississippi. The primary focus of both the court cases and the opinions is the impairment of a contractual obligation. While these opinions are useful in beginning the process of review, a more focused examination of the nature and limits of that obligation may provide a framework for the Mississippi Legislature to make any modifications.

1. Theory of a Retirement Benefit. The PERS Board requested a legal opinion from its counsel in 2010. That opinion (as well as the opinion later issued by the Attorney General) discusses the nature of a retirement benefit. The opinion raises and rejects the idea of a retirement benefit as a "gratuity" and then settles upon the view that a retirement benefit is subject to a "contract" which is set on the first day of covered employment.

According to the view of the Office of the Attorney General, an employee has a right, throughout an indeterminate number of years of employment, to a retirement structure that is at least as favorable as the minimum structure in place on the day he or she began covered employment. Both the gratuity and the contract-for-life views are based on theories of compensation that are not entirely consistent with a contemporary workforce. A more current analysis of retirement benefits would likely characterize them as an element of compensation, earned in sections over the course of employment in a manner similar to monthly payment of a salary or an hourly wage.

In recent decisions, courts have recognized a distinction between prior accruals and a future accrual. In *Swanson v. State of Minn.,* No. 62-CV-10-05285 (June 29, 2011), for example, the court held that retirees did not have a contractual right to a future cost-of-living adjustment ("COLA"). Likewise, in *Justus v. State of Colorado*, No. 2010-CV-1589 (June 29, 2011), the Court agreed with the Colorado retirement system that previously-accrued base pension for retirees is protected but future COLA accruals are not. Thus, it appears that an earn-as-you-go approach to accrual may be appropriate.

The legal opinion issued by the Attorney General describes an implied contract that exists for the entirety of the employment period. This view of the arrangement between the members and their employers overlooks the fact that all other terms and conditions of the employment relationship can be changed. For example, an employee's compensation could be adjusted downward or future vacation time could be limited. Given that the statute has no explicit promise for future benefit accruals, it is not consistent to apply a long-term, implicit contract to one element of the compensatory employer/employee relationship while all other elements of that same relationship are subject to change by the Legislature, the State Personnel Board, or other similar body.

2. Contractual Obligations. As noted in the Attorney General's opinion, any contract of the State of Mississippi is subject to the protections of both the United States and the Mississippi Constitutions. *U.S. Trust Co. v. New Jersey*, 431 U.S. 1 (1976). The application of the contract clauses of both constitutions is substantially similar with respect to the system—an enforceable contractual interest may not be eliminated by the amendment[3] or repeal of a statute.

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1. Although each member of the legal subcommittee is a practicing lawyer, this report is not a legal opinion issued by any firm or individual member, and it cannot be relied upon as such.

2 In the private sector, the answer to whether benefit modifications may be made is clear. Participants in private plans are subject to the protections of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the Internal Revenue Code of 1986, as amended (the "Code"). ERISA and the Code contain companion provisions requiring that no "accrued benefit" be reduced and that a 45-day notice be provided if a plan sponsor intends to lessen or cease future accruals. An accrued benefit is an amount actually earned through service. Under a private plan, any change to future benefit accruals is permissible, if notice is properly given.

3. The legislature retains the right to amend or repeal legislation without an express reservation of rights. U.S. Trust Co., 431 U.S. at 17; Musgrove v. Vicksburg and Nashville RR Co., 50 Miss. 677 (Miss. 1874). Only an enforceable contractual interest protected by the United States or Mississippi Constitutions inhibits that right.

There are clear contractual rights that a member earns during the course of his or her employment. See *PERS v. Porter,* 763 So.2d 845 (Miss. 2000) (member's right to designate any beneficiary accrues on the first day of membership). With respect to the system, the question that remains unanswered by the court is whether there are other rights that accrue on the first day of membership. If not, prospective changes to a retirement system do not impair contractual obligations. *See Swanson,* at page 15-16.

In addition to the right to designate a beneficiary, the types of benefits that would likely accrue upon membership would be items such as the right to choose between certain optional forms of benefit payment. In most cases, the contractual right to a particular amount of benefit would accrue quarterly or annually. For example, service credit accrues quarterly in the system. Under this view, the quarterly accrual does not become a contractual right until all service conditions are satisfied. Another example of a type of benefit that is likely to accrue on an on-going basis is the determination of high-four compensation [4]. The subcommittee thinks that this benefit accrues annually. This means that each year, a member's minimum compensation for purposes of a retirement allowance is re-set. Once that amount is determined, the subcommittee thinks it is unlikely that it can be reduced.

3. The Porter Case. The Mississippi Supreme Court's primary discussion of the status of governmental retirement benefits occurred in *Porter,* in which a member's beneficiary designation was disregarded by the PERS Claims Committee. When Mr. Porter joined the system, he had an unrestricted right to name anyone as his beneficiary. After several years of participation, Mr. Porter designated his sister as his beneficiary. Subsequent to his designation, the statute governing beneficiary designations was changed. The new statute required that any pre-retirement survivor annuity be paid to a member's surviving spouse, regardless of any beneficiary designation. The Supreme Court held that Mr. Porter had a contractual right to name any beneficiary he wished.

While the *Porter* case is somewhat instructive, the contractual right that arises under *Porter* is not clearly applicable to future benefit accruals. Mr. Porter performed service with a PERS-covered employer (the City of Greenville) for nearly 12 years before the Legislature sought to limit his beneficiary designation. He died with 17.5 years of service with the City of Greenville. Clearly, he had earned a substantial benefit under the system prior to the change. The statutory change failed to take into account Mr. Porter's accrued benefit. It simply applied the change to the entire benefit, thus depriving him of the right to name a beneficiary for the benefit earned before the change. Aside from its limited holding, the *Porter* case does not address whether the same result would have been reached if the statute had bifurcated the benefit between amounts earned before the change and amounts earned after the change.

Porter suggests another possible result. If the right to future benefit accruals is vested on the first day of coverage, the limits of that protection could be set by the statute in place on that day. See *Porter*, 763 So. 2d at 850 (contractual obligation depends upon terms on the day the contract is made). Thus, at a minimum, future accruals could be rolled back to the rates that existed when a member joined the system. At least one other state has indicated a willingness to apply this standard. See *Denning v. KPERS*, 180 P.3d 564 (Kan. 2008). Although this type of arrangement might provide some flexibility for the Legislature, it is likely to pose an administrative burden; thus, the subcommittee believes that more attention should be focused on separating the types of benefits that accrue upon membership and those that accrue annually or quarterly.

4. Other Issues. While the subcommittee believes that issues with future accruals may be resolved as described above, there are other items that the Legislature should consider. First, Section 272-A of the Constitution requires that no benefit increases may be made by the Legislature unless funds are available or concurrent funding provisions are made. The subcommittee's review of the changes in the system over the last few years has not shown clear compliance with this requirement.

Second, assuming that the contract covers future services, it can, nonetheless, be modified. The circumstances under which it may be modified, however, are somewhat limited. As part of any such modification, the Legislature may consider the system in the aggregate. See *Swanson*, at page 23 ("In exercising its authority here, the legislative change to the statutory adjustment formula was a comprehensive package of amendments that spread the burden and sacrifice of stabilizing the Plans across all members, the State, and the taxpayers"). Preserving the solvency of the system is a consideration in making any more aggressive changes.

4. Under the PERS rules, the high-four are not required to be consecutive and not even required to be consistent. They may be calculated partially on a fiscal basis and partially on a calendar basis as long as overlapping months are not used.

5. Application of the Rules. As an initial note to this final section, the subcommittee reiterates its belief that the potential changes set forth below are within the realm of possible changes. It is up to the committee as a whole to determine which changes it wishes to endorse.

a. New Hires. One area of agreement between every reviewer and commentator whose work the subcommittee has examined is that the Legislature may apply new standards of retirement (for example, accrual rates, contribution rates, optional forms of benefit, etc.) to new hires. The subcommittee agrees with this analysis.

b. Current Employees. Current employees covered by the system have accrued a benefit although it continues to grow with additional service. Some of those employees have completed the service vesting for those benefits, and some have not. It is not likely that "vested" status is determinative of an employee's right to an accrued benefit. Thus, the legal subcommittee believes it is likely that compensation and service earned are accrued benefits with contractual protection. However, the subcommittee thinks that the following changes may likely be made:

i. Applying a retirement age requirement for future benefit accruals with a reduction for early retirement on those future accruals;
ii. Removing disability coverage from the system for non-disabled members;
iii. Requiring the payment of actuarial cost for future purchases of service credit, which is currently in place;
iv. Modifying the compensation calculation to four consecutive years and limiting the allowable compensation, provided that a baseline accrued benefit is set;
v. Eliminating stacking for future accruals;
vi. Eliminating or reducing leave pay as compensation for future accruals;
vii. Eliminating the lump sum option for future accruals;
viii. Reducing the rate of future accruals; and
ix. Changing the COLA calculation

c. Retirees. Retirees have performed service and earned annual accruals. The subcommittee believes that the great likelihood is that these benefits are protected under the contracts clause. The annual three percent increase in benefits is likely a future accrual and not a benefit earned for prior service. Thus, it may be permissible to make a change in future accruals of the three percent cost-of-living adjustment. The subcommittee does not recommend reducing the COLA already earned. In addition, the subcommittee believes that benefits could be entirely suspended if a member returns to employment in a covered position. For example, a 55-year-old member who has been retired for 10 years receives a $13,000 annual COLA. If the Legislature amended the statute to provide that no additional COLA would be provided until a member reaches a certain age, the member would continue to receive the COLA already earned ($13,000) but would not earn additional accruals until reaching the specified age.

VI Policy Recommendations

The Study Commission discussed retirement plan structure, benefit provisions, and other aspects of PERS during their work. To help guide their work, the Study Commission set forth a series of goals, including:

1. Reduce the overall contributions (employer and employee) to less than 15 percent of pay within seven years. This would help ensure a reasonable ratio between employer and employee contributions. Potential goals could be to return to the original ratio where employees paid 60 percent of the contribution and employer paid 40 percent or achieve a ratio closer to 50 percent for both groups;
2. Eliminate as many distinctions between new hires and grandfathered employees as possible;
3. Structure the benefits consistent with a policy that does not encourage participants to stop working for the state or other participating employer prior to age 62;
4. Increase funding to a "healthy" (such as 80 percent funded status) over a seven-year period;
5. Simplify the administration;
6. Lower the vesting period to encourage individuals to seek public employment; and
7. Ensure best practices in all areas (financial, investment, management, etc) are in place.

GRS developed an analysis document with potential changes that could be made to improve PERS in accordance with the goals of the Study Commission. GRS's review was designed to evaluate the long-term viability of PERS in light of the stated goals and objectives of the Study Commission by reviewing and analyzing:

1. The current financial and funding structure;
2. The structure and plan provisions of PERS;
3. The actuarial assumptions;
4. Results based upon 10-year projections under varying scenarios.

The Study Commission voted to include the GRS document in its entirety as an appendix to this report. While the Study Commission does not endorse all recommendations in the GRS document, the Study Commission did use much of the data, cost-estimates, and other information from GRS as a basis for their final policy recommendations.

Affordable, Sustainable and Fair

The study commission felt that any recommendations should be developed with an eye toward creating a plan that is fair, affordable to both the beneficiaries and taxpayers, and sustainable in the long-term. A plan that is affordable will necessarily lend itself to becoming more sustainable in the long-term; likewise, a plan that is fair will not be susceptible to some of the "mischief" items currently in existence under the current plan structure of PERS.

The Study Commission discussed whether the current retirement plan is affordable. As noted earlier in the report, the employer's rate has substantially increased in recent years. In fact, the employer's contribution rate will have increased three times over the course of one year, from 12 percent of payroll to 14.26 percent in July 2012, if current projections hold true. This is an 18.8 percent increase – in one year.

Considering the state's budget, the Study Commission felt it was important to note that the projected increase in the employer contribution rate is estimated to cost nearly $26.3 million for Fiscal Year 2013 according to estimates from the Department of Finance and Administration. As Mississippi climbs out of the economic downturn, this additional cost will put pressure on lawmakers and agency directors, especially since many economists expect state revenues to fall below pre-recession levels until Fiscal Year 2014 or later.

As discussed earlier, the PERS Board has the authority to assess the state and other employer entities at whatever rate is necessary, as determined by the PERS actuary, to keep the system within the 30-year amortization period. The current reliance on increased employer contributions to "right the ship" is a point of concern for the Study Commission. The Study Commission agrees that any system is sustainable in the long-term as long as the state and other employers can continue to increase contribution amounts to the system, but state and other employers cannot financially sustain this increase. Self-correction, or relying on the state, city, county, public schools, and other employers to pay increased contribution rates, is simply not affordable for taxpayer-funded entities.

Not only is the employer contributing more in the current scenario, but the contribution rate for employees has also increased within the last two years. Although the increase from 7.25 percent to nine percent of payroll was the first time the employee's contribution rate has been changed since 1991, this increase represents a decrease in an employee's take-home pay. The Study Commission believes that the current system, which demands more money from the employer and employee, is not affordable, particularly in this economic climate.

If the projected rate increase goes to 14.26 percent for the employer in July 2012, the total cost to both employees and the employer would be 23.26 percent of covered payroll. This is a substantial percentage to both employees and employers. The Study Commission believes it is possible to provide a meaningful and reasonable retirement benefit for state, school, county, municipal, and other members without such a large cost. The Legislature should review the overall cost as part of its monitoring and maintenance of PERS.

Retirement Age and Eligibility for Drawing Benefits

The Study Commission debated the appropriate parameters for drawing retirement as well as the normal retirement age. The Study Commission voted to recommend modification by the Legislature to provide that 62 would be the normal retirement age with the following tiers for drawing retirement:

- Eligible to draw full retirement at age 62 if vested;
- Eligible to draw full retirement at age 55 with 30 years or more of service, but with no cost-of-living adjustment until age 62; or
- Eligible to draw an actuarially reduced benefit before age 55, after completing 30 years of service.

Cost Impact of Proposed Changes

Employer Normal Cost		(1.61%)
Unfunded Accured Liability %		0.00%
Total Change in Employer Contribution		(1.61%)
Unfunded Accrued Liability $	$	-
Estimated Funded Status		64%
Estimated Increase in First Year Employer Dollar Contributions	$	(92,837,610)

** Since the cost estimates were based on a June 30, 2010 valuation date, June 30, 2010 was used as the date of change for this proposal.*

GRS valued the financial impact of these changes. Implementing these changes and lowering the vesting period from eight to four years (effective for current members' future service and all new hires) would decrease the employer contribution rate by 1.61 percent; increase the plan's funded status to 64 percent; and reduce first year employer contributions by $92.8 million.

PERS provided the Commission with information on the age at retirement for members over the last five years. One of every five people who retired in 2007 was 54 or younger, and retirement benefits are not actuarially reduced for an early retirement. Under the current system for members who were hired prior to July 1, 2011, a person with 25 years of service may retire regardless of age with a full, unreduced benefit. This means that two employees who work for the same number of years and level of pay but begin work at different ages will receive vastly different retirement benefits. The current system encourages members to leave state service as early as possible to begin drawing an unreduced benefit while these retirees may choose to work elsewhere. A 1998 PEER report has described the system as having "liberal early retirement provisions" available to individuals who "may even be pursuing second careers."

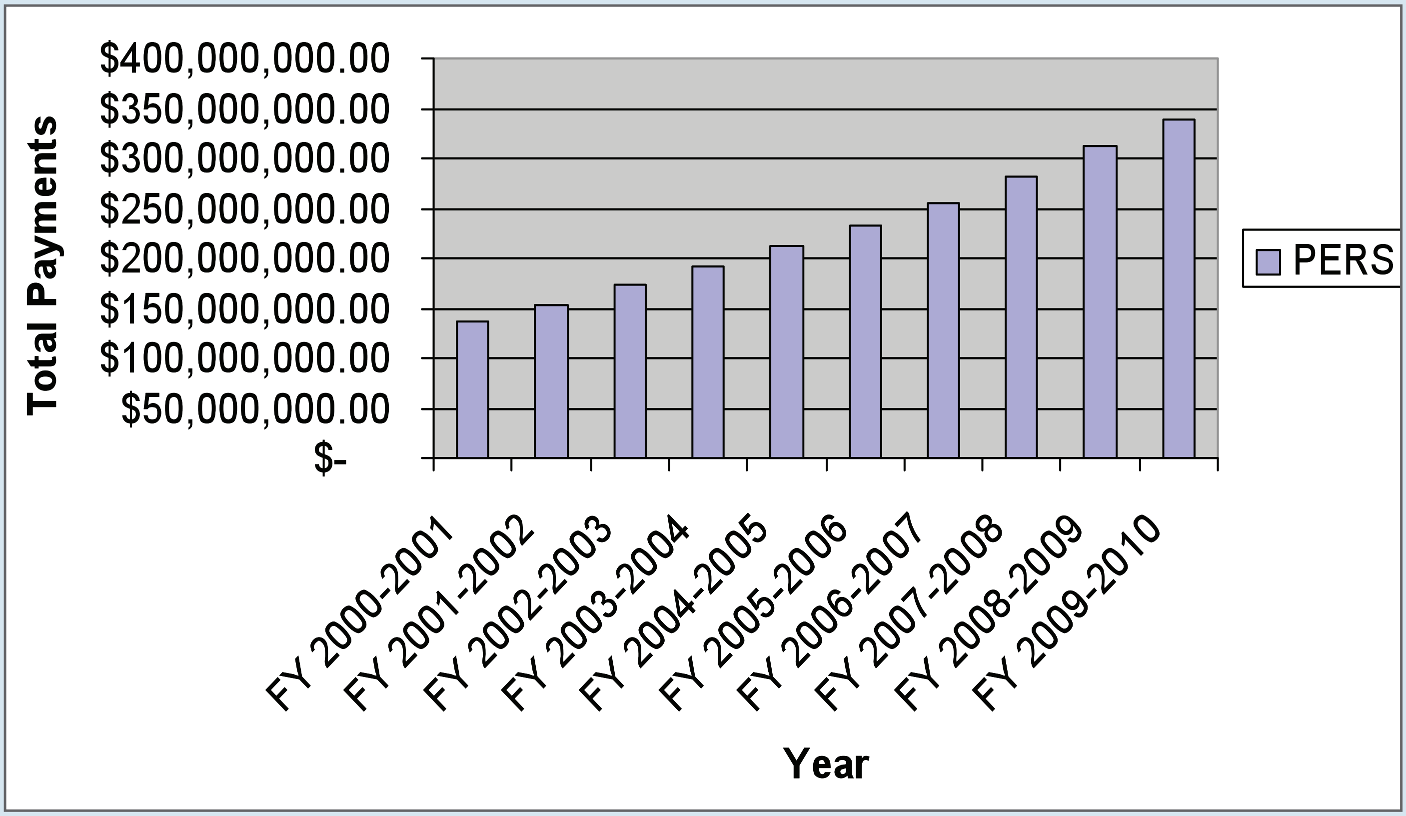
PERS Retirees and Beneficiaries by Age (Service, Disability and Survivor)

Benefit Recipients Over 100 Years of Age as of June 30, 2010

Number of recipients over 100 years	62
Annual years in retirement	38
Average annual base benefit	$4,356
Average annual COLA -	$8,757

Courtesy of PERS

Cost of Living Adjustments



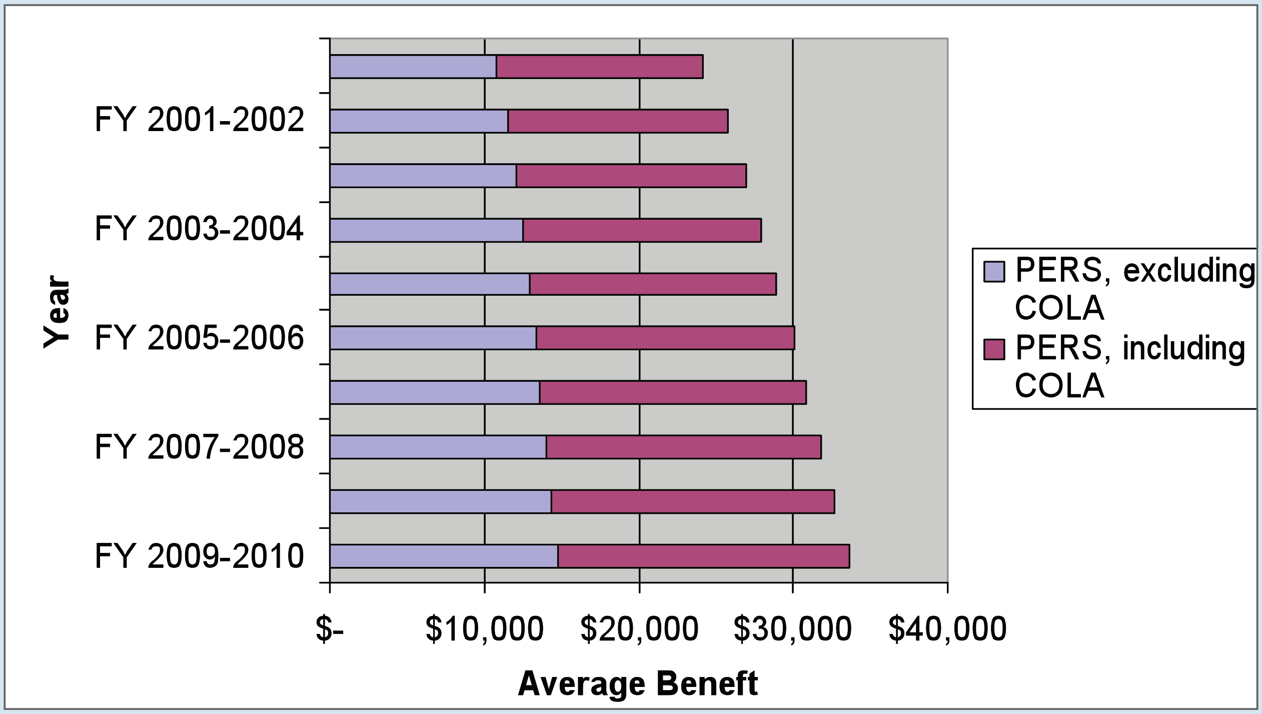
Cost of Living Adjustments (COLA)

Cost-of-living adjustments are common in public retirement systems and are designed to help ensure a beneficiary's payments are keeping pace with inflation over the course of their retirement.

The cost-of-living adjustment is one of the costliest benefit provisions included in the PERS plan, accounting for an estimated 25 percent of the plan's payouts during a single year. For example, in Fiscal Year 2011, PERS paid out approximately $1.7 billion in benefit payments; of that total, $369 million was attributed to COLA payments. The expected increase in COLA payouts is $40 million, for a cumulative COLA payout of $409 million in Fiscal Year 2012.

Currently, the COLA is set by state law at three percent simple increase each year until age 55; after age 55, the COLA compounds annually. This statutory COLA increase provision means that Mississippi has no mechanism to ensure benefit payments are tracking inflation and no way to rein in costs associated with a COLA that outpaces inflation.

Average Annual Retirement Benefit



As a comparison, the Social Security COLA is tied to the Consumer Price Index (CPI). Because the CPI measure did not increase above the last quarter of 2008 for two years, Social Security beneficiaries did not receive a COLA in years 2010 and 2011. The Social Security Administration recently announced that the cost-of-living had increased for the current year, so beneficiaries will receive an adjustment for 2012. Mississippi's COLA provisions, however, do not allow for such flexibility. The state's statutory policy to increase payments by three percent every year and compound those payments after age 55 is contrary to the very nature of a cost-of-living adjustment: to ensure that payments are adjusted to meet the rising and falling "costs of living."

For example, PERS beneficiaries received at least a nine percent (or higher) cost-of-living adjustment from 2008 to 2011. During this same time period, inflation rose half that amount – 4.54 percent – based on the latest Consumer Price Index data available. Additional study by GRS found that the system is currently paying out approximately $10 million more in COLA benefits each year than it would if the COLA program were indexed to the CPI. Their analysis also indicated that some members are, on average, receiving more in COLA than they actually lost through inflation.

The Study Commission recommended two provisions related to the cost-of-living adjustment, which is commonly referred to as the "13th check." This is due to the fact that some PERS beneficiaries choose to receive their cost-of-living adjustment as a one-time payment during the course of the year. The Study Commission did not recommend any changes to the current option to take the cost-of-living adjustment as a lump sum payment ("13th check").

The Study Commission recommended freezing the current cost-of-living for three years. This means that current retirees would receive the same amount of their COLA as the last year; however, it would not increase for three years above its current amount. For individuals not yet receiving a COLA, this would mean that no COLA would be received for three years after retirement. GRS concluded that implementing these changes for future accruals of current members and retirees, as well as all new hires, would result in a reduction in contributions by 1.29 percent; an estimated funded status of 67 percent; and a reduction in first year employer contributions of $74.3 million.

The Study Commission also recommended returning to the state's former practice of tying the cost-of-living adjustment to a measurement of the actual cost of living, such as the Consumer Price Index, and capping the increase at three percent. This recommendation is also included in the GRS review of PERS. Relating the COLA to an inflation index, concludes GRS in their report, "will reduce long-term costs if there are periods in the future where the increase in inflation is less than 3%. It also prevents a situation from occurring where members who retire during low periods of inflation could actually increase their purchasing power by receiving a fixed 3% increase."

Cost Impact of Proposed Changes

Employer Normal Cost	(0.05%)
Unfunded Accured Liability %	(1.24%)
Total Change in Contributions	(1.29%)
Unfunded Accrued Liability $	$(1,295,809,292)
Estimated Funded Status	67%
Estimated Increase in First Year Employer Dollar Contributions	$ (74,329,652)

Final Average Compensation

A major concern for the Study Commission was to recommend ways to alleviate the current "mischief" that appears to be available to members of the PERS system. Broad statutes and policies allow some abuses to creep in; and, in some cases, the Study Commission felt that statutorily-authorized provisions were themselves abuses of the system. For example, current law provides for an opportunity for individuals to hold multiple jobs with PERS-covered employers and "stack" those salaries to increase their final average compensation. "Stacking" is one way that employees may spike their final average compensation.

GRS analyzed spiking, which occurs when members increase one of more years of their covered compensation by purposefully loading up on overtime; taking on special assignments or duties right before retirement; including lump sums that are payable at retirement; and working with the employer to get a large salary increase due to a promotion or change in jobs immediately preceding retirement.

GRS describes the issue:

> *This is known as "spiking" because the final average compensation is no longer reflective of the member's career income when this activity occurs. The longer the averaging period is, the less of an impact this spiking will have on the computation. However, using a longer final averaging period also subjects the average to more erosion from inflation. Therefore, we recommend using an indexed final average computation if the averaging period exceeds five years. By indexing the compensation in the final averaging period, the inflation erosion is reduced or eliminated. Examples of salary spiking and using an indexed final average computation are shown below.*
>
> *We understand that PERS currently has a limit on the increases during the last 24 months in covered compensation that can be included in the computation of the final average compensation. However, we also understand (from PERS staff) that there are currently so many legislative exceptions to this limit that it almost never used to actually limit the computation.*

Salary Spiking Example

Year Prior to Retirement	Base Earnings	Overtime	Unused Leave Pay	Total Covered Earnings
1	$ 50,000	$ 20,000	$ 5,769	$ 75,769
2	$ 47,847	$ 5,000	$ -	$ 52,847
3	$ 45,743	$ 4,000	$ -	$ 49,743
4	$ 43,606	$ 5,000	$ -	$ 48,606
5	$ 41,530	$ 4,000	$ -	$ 45,530
6	$ 40,716	$ 3,000	$ -	$ 43,716
7	$ 38,411	$ 4,000	$ -	$ 42,411
8	$ 35,566	$ 5,000	$ -	$ 40,566
4-year average				$ 56,741
5-year average				$ 54,499
6-year average				$ 52,702
7-year average				$ 51,232
8-year average				$ 49,899

Simplifying the methodology by which PERS uses to determine an individual's final average compensation would help address salary "spiking" as well as salary "stacking." According to GRS, the current methodology is

> *"calculated using your four highest years of salary plus any unused leave payment up to 240 hours. The years do not have to be consecutive, but they do have to be the equivalent of not more than 48 months of earned compensation. To determine your four highest years, PERS considers these scenarios:*
>
> - four highest fiscal years of earned compensation;
> - four highest calendar years of earned compensation;
> - combination of four highest fiscal and calendar years of earned compensation that do not overlap; or
> - final 48 months of earned compensation prior to termination of employment."

In its 2010 audit of PERS, GRS recommended that PERS have their actuary study any activity that appears to be manipulating the plan provisions, including salary "stacking" and "spiking"; the first study of this activity is scheduled for the 2012 PERS experience study.

The Study Commission recommends that to help reduce abuses in the system, the final average compensation of a PERS retiree should be based on four consecutive years of service based on the employee's base pay. The Legislature should study whether it is appropriate to include unused leave, overtime pay, special pay, and per diem and travel (in the case of legislators) as part of an individual's final average compensation.

The Study Commission also recommends that consideration be given to using full time equivalent compensation for covered members who are not full time (along with crediting partial years of service for benefit computations, but full years of service for eligibility) to help PERS manage the stacking of salaries.

The Study Commission recommends the Legislature review all statutes related to PERS and consider the implication of certain statutes that may allow for "spiking," "stacking" of salaries, or other manipulations within the PERS plan.

Analysis of Costs

The Study Commission believes the Legislature should review employer practices that result in inequitable costs to the PERS system. Participating employers who offer early retirement incentives may shift compensation costs onto the plan. Because PERS is a cost-sharing employer plan, however, those costs are distributed across all members of the plan. The Legislature should consider, among other things, an analysis of individual or employer-type experience for PERS employers to determine what employers actually cost the system. This data will be helpful for recognizing if and where changes should be introduced into the PERS system.

Total System Active Members by Employer Group

Total System Active Employees as of June 30, 2011 = 163,335

Courtesy of PERS

***includes hospitals, libraries and other juristic entities**

Legislative Best Practices

The Study Commission recommends that the Legislature require a fiscal note and one-year study period for legislation modifying PERS plan design before it can be considered for enactment. This one-year study period and fiscal analysis would afford legislators, members of the public, retirees, and current and future public employees an opportunity to fully understand the potential impact of new legislation to the PERS system, both in the short and long-terms. The Study Commission noted that such a practice may have prevented the unfunded benefit increases of the late 1990s and early 2000s from passage, which would have resulted in PERS remaining on stable footing even during the recent economic downturn.

Vesting Period

The Study Commission recommends that the vesting period be lowered from eight years to four years. The Study Commission felt that it was important that workers be entitled to some retirement allowance after four years of service and that eight years was too lengthy of a period to work to become eligible for a benefit.

GRS analysis of vesting concluded that lowering the vesting period from eight years to four years may, in fact, have a positive impact on the plan:

PERS currently pays 3.5% interest on member contributions. In addition, the current valuation assumptions include an 8.0% investment return assumption and an assumption that all members who are vested will leave their contributions on deposit upon termination prior to retirement and draw a deferred retirement (referred to as a "0% forfeiture assumption"). The forfeiture assumption, in combination with the assumed arbitrage for deferred members (PERS pays 3.5% and assumes to earn 8.0%) and the high member contribution rate (9.0%), results in 4 year vesting provision being slightly less costly than an 8 year vesting provision when valued using the current valuation model. Of course, this may not be the case practice if actual experience differs from assumed experience. However, we expect that the actual difference in costs for these provisions is minimal.

Supplemental Legislative Retirement Plan

The Study Commission recommends that the Legislature review whether or not it is appropriate to have an additional benefit for members of the Legislature and the President of the Senate, particularly when these individuals are also entitled to a normal PERS benefit.

For reference purposes, the Supplemental Legislative Retirement Plan (SLRP) was established July 1989. The plan covers all members of the Mississippi State Legislature and the person serving as the President of the Senate (Lieutenant Governor). The Governor is not a member of SLRP. Those serving when SLRP became effective on July 1, 1989, had 30 days to waive membership. Those elected after July 1, 1989, automatically become members. According to the PERS Facts & Figures booklet, there are 174 active members in SLRP; 61 inactive members; and 147 retirees and beneficiaries.

The employee contribution for SLRP is three percent and the employer contribution rate is 7.4 percent. These contributions are in addition to the contribution paid by the employee and employer on covered wages reported in the PERS plan. At June 30, 2011, SLRP had a funded status of 73.1 percent, which represented a decrease from 77.5 percent at June 30, 2010. SLRP has declined over the last decade, from a funded status of 85.9 percent at June 30, 2002 to its current funded status of 73.1 percent. The plan's unfunded accrued liability is $4.9 million, which represents an increase over $3.8 million at June 30, 2010.

Eligibility for benefits under SLRP is contingent upon eligibility for benefits under PERS (since SLRP members are also members of PERS and since SLRP is a supplemental pension plan). Any SLRP member eligible to retire under the PERS Plan who has also contributed to SLRP will be entitled to a benefit equal to 50 percent of that payable under the PERS provisions for service credit covered by both PERS and SLRP in addition to his or her PERS benefit.

The SLRP service retirement benefit calculation formula is one percent of average compensation for the first 25 years of creditable service plus 1.25 percent of average compensation for all years of creditable service over 25 years.

SLRP benefits also include a cost-of-living adjustment, or COLA. The COLA formula for SLRP mirrors the formula for PERS: three percent fixed until age 55; 3 percent compounded after age 55. There is no provision for limited re-employment where a retiree can draw both SLRP benefits and be employed in a SLRP covered position. Thus, if a SLRP retiree returns to employment covered under the SLRP, the member will have his retirement benefits terminated and will again become a contributing member of the plan. However, a SLRP retiree can be employed by a PERS employer in a non-SLRP position and continue to draw SLRP benefits.

Funding Policy

The Study Commission notes that the GRS report suggests a more substantive funding policy for PERS, including a plan to reduce the amortization period, addressing a volatile investment environment, and addressing the allocation of risk and contributions between the employer and employee.

GRS provides specific recommendations to improve the funding policy in accordance with goals set forth by the Study Commission:

We understand PERS funding policy to be: the employer contribution rate will be the greater of 1) the employer contribution rate from the prior year; or 2) the rate necessary to pay the normal cost plus a 30 year amortization of the unfunded actuarial accrued liability (UAAL).

In line with the goal of improving the funded status of PERS, we recommend consideration of a more aggressive funding policy. One such funding policy was illustrated on pages 48-49. Others could be as simple as just closing (reducing it by 1 year, each year) the amortization period until such time as the fund has achieved a stronger funded status (such as 80% or 90%). In addition to the accelerated funding that this will yield, there may also be reporting advantages. The Governmental Accountings Standards Board (GASB) has recently issued new exposure drafts for Statements No. 25 and No. 27, which control how retirement systems (Statement No. 25) and Plan Sponsors (Statement No. 27) report pension liabilities in their annual reports. Under the currently proposed rules in the exposure draft, plans must use a blended interest rate to report liabilities under certain circumstances. The blended rate is a blend of a risk free interest rate and the assumed rate of return used in the valuation (if it qualifies as a market rate of return). As we currently understand the proposed rules (which are still subject to change) any plan that uses an open (or fixed) amortization period will be subject to this blending requirement. If the market rate/valuation assumption is 8.0% and the risk free rate is 4.0%, then PERS can expect to be required to use an investment rate of return assumption of 6.5% to 7.25% (depending on its level of funding at the time of the measurement) for determining liabilities that will need to be reported on its and the plan sponsors' balance sheets. A liability determined with this lower investment return assumption could be substantially higher that what will be shown in the valuation report. Please see the Appendix for our Newsletter which contains more details regarding the new proposed GASB rules.

In addition, we recommend that PERS consider creating a more detailed funding policy that provides guidance on additional situations that PERS may currently face or may face in the future. These situations include dealing with:

- Unfunded Actuarial Accrued Liabilities (UAAL) attributable to Retirees and Beneficiaries;
- UAAL attributable to new benefits (or benefit increases);
- A declining employer contribution due to an increased funded status;
- A volatile market environment;
- A high member contribution rate;
- Future gain and loss sharing.
- A plan for sharing the risks between members and the plan sponsor.

Examples of policies that deal with such situations include:

- Financing unfunded retiree liabilities over a period that does not exceed the expected lifetime of the group (such as 15 years). Along with this the policy should explicitly determine how the assets are applied in order to determine if there is a UAAL for retirees. This could be determined by applying all assets to the retiree liabilities or by applying the assets net of the active employee contributions to retiree liabilities. As of June 30, 2010, the former process would result in retiree liabilities being 100% funded while the latter process would result in retiree liabilities being 94.7% funded.
- Financing any new liabilities created from benefit changes in a lump sum or over an extremely short period (such as 1 to 5 years). While this is really a legislative decision, we have found legislatures are increasingly looking to retirement systems for guidance and recommendations in recent years. While the legislature is not bound by any PERS policy, such a policy would provide legislators with a best practices approach when they are making decisions and determining affordability.
- Establishing a minimum employer contribution. This policy could also include direction as to what to do with any portion of employer contribution (due to the minimum) above amounts that would otherwise be required. This could include funding a contribution stabilization fund, contributing to hybrid accounts, contributing to deferred compensation plans, etc.
- Determining if and when member contributions should be reduced or increased. While most of the investment and mortality risk is borne by employers in a defined benefit plan, some of that risk is shared with members in the form of increased member contributions or reduced benefits (both of which have occurred in this plan).

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