

THE MISSISSIPPI LEGISLATURE

The Joint Committee on Performance Evaluation and Expenditure Review

Report # 591

An Update on the Financial Soundness of the Mississippi Public Employees' Retirement System and Related Legal Issues: 2014

Executive Summary

Introduction

PEER's 2012 report *The Public Employees' Retirement System of Mississippi: A Review of Selected Issues Related to Financial Soundness* ([Report #564](#), December 11, 2012) set out the attributes of a financially sound retirement system. This report includes an update on the financial performance of the system and projected funding levels.

Because of the ever-changing legal landscape affecting public pensions, this report also provides an update on results of litigation from other states since December 2013 that addresses employees' contractual rights in public retirement systems.

Update on Financial Soundness of PERS

Actuarial Soundness and Sustainability

Actuarial soundness and sustainability are two of the major contributing factors the PEER Committee established as components of financial soundness in its 2012 report on PERS. The focus of these two concepts should be to create a system and actuarial assumption models that are able to be upheld and defended in light of all relevant environmental conditions, including contractual obligations involved and the potential economic consequences of abrogating those obligations.

2014 Update: Actuarial Soundness

The PERS Board, with assistance from its staff and other contractual advisors, endeavors to maintain the actuarial soundness of the plan by monitoring all components used in PERS's actuarial model. At present, the actuarial model assumes an annual increase of 4.25% for total annual payroll made up of component factors for price inflation and real wage growth. In reality, total payroll increased 0.19% from FY 2013 to FY 2014, with an average annual payroll increase of 0.02% over the last five years.

2014 Update: Sustainability

The current PERS funding policy is designed to address the volatility of employer contribution rates within the PERS system by setting the employer contribution rate percentage to a fixed rate of 15.75% of annual compensation. The policy also targets an 80% funding level by 2042 while still reducing the plan's unfunded actuarial accrued liability. In addition to these effects, the funding policy change will have the effect of creating more long-term sustainability within the PERS system.

Risk Management and Investment Management

Risk management and investment management should provide a long-term framework for the system that will manage the plan's long-term risk environment in ways that allow it a reasonable opportunity to collect or earn sufficient assets to meet its benefit obligations.

2014 Update: Risk Management

As of June 30, 2014, the PERS funding ratio was 61.0%, an increase from 57.7% as of June 30, 2013. Under PERS's current strategy for risk management, if successful, the funding ratio will continue to improve and current projections estimate the system will reach a funding level of approximately 80% in 2031, which is eleven years sooner than the plan's original goal.

2014 Update: Investment Management

For Fiscal Year 2014, the combined investment portfolio experienced a return of 18.6% and the market value of the system's assets was approximately \$24.9 billion. The PERS Board of Trustees adopted an asset allocation model effective July 2013 to set investment level targets for the PERS investment portfolio.

Changes to be Considered for PERS

PEER notes two possible changes that could be considered for the PERS system: changing from an eight-year vesting period to a four-year vesting period and requiring PERS to study the cost and pervasiveness of "stacking" and "spiking" in order to make additional changes in state law to prevent these practices.

Changing from an Eight-Year Vesting Period to a Four-Year Vesting Period

Based on calculations by the PERS actuary as of June 30, 2013, changing from an eight-year vesting period to a four-year vesting period would have had a negligible affect on the system's funding ratio. In contemplating such a change, one factor to consider is the potential advantage of offering a shorter vesting period to help attract potential public employees.

Curbing "Stacking" and "Spiking" Practices

"Stacking" occurs when a member holds two or more positions covered by PERS and is allowed to use the salaries from these multiple positions in the computation of average compensation for purposes of calculating retirement benefits. An example would be a teacher who also serves on the city council or a full-time state employee who works part-time for the county.

"Spiking" occurs when a member's salary is artificially increased during the "high four" years for the purpose of increasing the member's retirement benefits.¹ An example would be a policeman who works excessive overtime or a state employee who is awarded salary increases during the "high four" period in order to spike or increase retirement income.

Recent changes to MISS. CODE ANN. §25-11-103 (1972) already limit the use of "stacking" and "spiking" to increase an individual's retirement benefits. In order to further limit these practices, the Legislature should require PERS to study the cost and pervasiveness of "stacking" and "spiking."

Recent Legal Actions Involving States' Attempts to Modify Retirement Benefits for Current Pension Members and Retirees

In its 2012 report on PERS, PEER provided information regarding possible legal risks associated with making changes in the current retirement system for retirees and current PERS members. That report set out the following principles pertinent to the Mississippi retirement system as administered by PERS:

- There exists a contractual relationship between the employee members of PERS and the state. This relationship also exists between retirees and the state. An employee's contractual rights accrue at the time of employment.
- Changes in benefits for retirees and current employees, whether past or future, may violate the contracts clauses of the Mississippi and United States constitutions.
- Such impairments, if substantial, are not tolerated under law unless they are reasonable and unless they are also

followed with compensating benefits to the employee or retiree. This is known as the California Rule.

This report provides an overview of significant cases that have been rendered or filed in 2014.

2014 Update: States' Modifications of Members' Contribution Rates, Minimum Years to Retirement, or Value of Service Credit

Several states' legislative bodies have enacted laws changing their retirement systems' contribution rates, the number of years to retirement, and the value of service credit. In some instances, employees or unions have objected to the changes and sought judicial relief by asserting that the changes violated state and federal constitutional provisions. In the cases litigated, the contractual rights of employees and retirees have been upheld. Some jurisdictions take a more restrictive view of contractual rights than do others.

The report includes summaries of cases in instances wherein an appellate court has rendered a final decision or there is a trial decision that is final. These cases include those in California, Illinois, Louisiana, New Hampshire, Ohio, Rhode Island, and Texas (see pages 14 through 17 of this report).

2014 Update: States' Modifications of Cost-of-Living Adjustments

Cost-of-living adjustments, usually called COLAs, have been the subject of considerable recent litigation. COLAs are often provided in accordance with a strict formula set in law. In some cases, the COLA is calculated on an ad hoc basis driven by the pension plan's investment performance.

Several litigants have challenged the calculation of cost-of-living adjustments. Jurisdictions have split on the issue of whether COLAs are a constitutionally protected contractual or property right.

This report summarizes recent case law on COLA modification or elimination in Arizona, Colorado, Maine, New Jersey, Washington, and Oregon (see pages 17 through 20 of this report).

2014 Update: Analysis of Recent Legal Actions

While the litigation so far resolved is of little interest to Mississippi, ongoing litigation in California, Rhode Island, and Oregon could have an impact, as these states have historically offered considerable protection to both past and future benefits. As recently as 2013, a publication of the Federalist Society, an organization noted for its conservative positions on constitutional matters, stressed that changes to pension systems utilizing the California Rule appear to be quite difficult, as they are quite protective of members' interests.²

COLA litigation of late has shown a marked tendency to favor state attempts to control or modify COLA calculations. In view of

the fact that PERS's COLA, provided for in MISS. CODE ANN. Section 25-11-112 (1972), specifically provides a method for calculating a COLA for all members of the retirement system on or before July 1, 2011, and a different one for persons who became members after that date, it would appear that Mississippi has taken the step to promise unequivocally a COLA utilizing a set formula for its PERS members.

Conclusion

PEER notes that sound financial management is a long-term commitment to a disciplined, prudent process of managing for risk. While any particular year of returns may be high or low, sound financial management requires the Legislature to look more closely at how the system sets reasonable goals and manages for the inevitable movements that the market will experience over a long period. Continued competent, prudent management gives PEER every indication that PERS is moving toward reducing both the amortization period for the system and reducing the unfunded accrued liability.

¹ Calculation of an individual's retirement benefit is based on the highest four years of salary.

² See Skeel, *Can Pensions Be Restructured in Detroit's Municipal Bankruptcy?* The Federalist Society, October 2013, Note 9.



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