Defined Benefit Design for the Next Generation

2016 South Dakota Legislative Session - Senate Bill 13
Sponsored by the South Dakota Retirement System (SDRS)

After extensive review and study over several years, the Board of Trustees of the South Dakota Retirement System sponsored Senate Bill 13 (SB 13) in the 2016 South Dakota legislative session. The bill, the legislative handouts, and a White Paper on this restructuring of the SDRS hybrid defined benefit design for new members after June 30, 2017, are available on the SDRS website. The SDRS Board of Trustees is an active initiator of proposals to maintain the financial soundness of SDRS and promote sound pension policy.

The concepts and features in the restructured benefits have been broadly distributed to members of the plan, media, and all stakeholders. The proposal has received nearly universal support by members and public employers throughout the state. SB 13 passed both houses of the South Dakota Legislature with no dissenting votes and has been signed into law by the Governor.

SDRS is fully committed to the following principles:

- A defined benefit design is the most efficient and effective method to provide lifetime income protection
- Hybrid features should be used to enhance portability, share risks and balance benefits for all members, regardless of service length
- Certain flexible benefits that vary with investment results and inflation can enhance long-term sustainability
- A benefit structure that is equitable and soundly funded by fixed member and employer contributions
- Maintaining a fully funded system

SB 13 focuses on strengthening our commitment to these principles.

Our review revealed the following:

- The current SDRS benefit structure, like many systems, effectively encourages and promotes early retirement at a very high cost. This design was enacted and improved to make room for the baby boom generation. South Dakota now has a workforce shortage and these incentives are contrary to workforce needs.
- Class A members (our general employees-95 percent of active members) have benefits that are lower than the income replacement goals of the Board and the Class B members' (public safety and judicial) benefits are slightly higher than supported by their contribution rates.
- The SDRS COLA does not adjust to low inflation, significant subsides are provided to married members, and longer life expectancies have increased funding costs.
- Over 27 percent of our costs were due to subsidies-mostly due to early retirement incentives.

Based on these findings, the Board focused its efforts to design a new tier to meet its goals for sustainability, workforce needs, benefit sufficiency, and equity. By eliminating the cost of benefit subsidies and other features that exceed industry standards, the savings permitted a restructuring of benefits that met all its goals.

The Board of Trustees long-term income replacement goal is to replace 55 percent of pre-retirement income from SDRS for career members and lifetime income replacement of 85 percent when also considering SDRS, Social Security, and personal retirement saving of at least one times final salary at retirement. The Board of Trustees added the personal retirement savings goal recognizing the high and growing costs of retirement and the inability of public employees to accrue adequate savings. The SDRS income replacement goal and personal retirement savings goals will be achieved for new career members under the new design.

An important equity requirement of this restructuring is that the total normal cost of the new benefit structure essentially equals the normal cost of the existing structure. The two designs fit within one plan and avoid a subsidy from new members to existing members. Members hired before July 1, 2017, will be classified as Foundation members and new members after June 30, 2017, will be Generational members.

The new benefit design changes a number of plan features for Generational members:

- Normal Retirement Age – Class A and Class B judicial members increased from 65 to 67 -
  (Class B public safety members increased from 55 to 57)
- Early Retirement Eligibility – 10 years prior to Normal Retirement Age / 5 percent reduction per year
- No Special Early Retirement – eliminate all "Rule of" retirement eligibilities
- Benefit Formula – Class A members increased from 1.55 percent to 1.8 percent / no change to other classes
  Eliminate benefit leveling for pre-age 62 retirements
  Final Average Compensation increased from 3 years to 5 years
  Variable Retirement Account payable at retirement, death, or disability
- Post-Retirement Survivor Benefits – normal form changed from joint and 60 percent survivor to straight life. (Joint and 60 percent or joint and 100 percent survivor available as a reduced benefit)
- COLA changed from minimum of 2.1 percent to maximum of 3.1 percent based on funded status and CPI to CPI with minimum of 1.0 percent and a maximum that ranges from 2.1 percent to 3.1 percent based on funded status

The White Paper highlights the new design. While most of the changes are straightforward, the Variable Retirement Account is a new feature that the Board has considered for the last decade and works as follows:

- A portion of the employer contributions will be allocated to variable notional accounts for each Generational member
- The variable retirement contributions will initially be set at 1.5 percent of compensation, but the Board may change that amount based on future actuarial results
- These accounts remain in the SDRS Trust Fund, are invested by the South Dakota Investment Council along with all of the other plan assets, and will be annually credited with the actual returns of the plan
- The member will only have access to this account at retirement, death, or disability, and the accounts are not payable as a refund or termination benefit
- The member may annuitize the account based on the SDRS Supplemental Pension Benefit provisions, roll the balance to another qualified plan, or take a lump sum

This variable feature improves the sustainability of SDRS as a whole because the benefit liability associated with the variable retirement account rises and falls with the performance of the investments. At the same time it allows members to share directly in the investment results of the Investment Council. The Board supports the policy of providing fixed benefits that meet our lifetime income replacement objectives and variable benefits to meet personal retirement savings goals.

It should be noted that this design fits the South Dakota Retirement System, our fiscal and cultural environment, and the related fixed statutory contribution limitations. It represents a continuation and expansion of our current hybrid defined benefit design, but it may not be a practical design for others.