#591

Joint Legislative Committee on Performance Evaluation and Expenditure Review (PEER)

Report to
the Mississippi Legislature

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

Regarding the financial soundness of the Public Employees' Retirement System (PERS), PEER learned:

- Presently, PERS's 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.

- 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.

- 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 reach a level of approximately 80% in 2031, which is eleven years sooner than the plan's original goal.

- For Fiscal Year 2014, PERS's combined investment portfolio experienced a return of 18.6% and the market value of the system's assets was approximately $24.9 billion.

- The Legislature may wish to consider changing the system's vesting period from eight years to four years 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.

Regarding recent legal action to modify public pension benefits, ongoing litigation in California, Rhode Island, and Oregon could have an impact on Mississippi, as these states have historically offered considerable protection to both past and future benefits. Cost-of-living adjustment (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, set in law, specifically provides one method for calculating a COLA for members of the 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.

January 5, 2015

PEER: The Mississippi Legislature's Oversight Agency

The Mississippi Legislature created the Joint Legislative Committee on Performance Evaluation and Expenditure Review (PEER Committee) by statute in 1973. A joint committee, the PEER Committee is composed of seven members of the House of Representatives appointed by the Speaker and seven members of the Senate appointed by the Lieutenant Governor. Appointments are made for four-year terms, with one Senator and one Representative appointed from each of the U. S. Congressional Districts and three at-large members appointed from each house. Committee officers are elected by the membership, with officers alternating annually between the two houses. All Committee actions by statute require a majority vote of four Representatives and four Senators voting in the affirmative.

Mississippi's constitution gives the Legislature broad power to conduct examinations and investigations. PEER is authorized by law to review any public entity, including contractors supported in whole or in part by public funds, and to address any issues that may require legislative action. PEER has statutory access to all state and local records and has subpoena power to compel testimony or the production of documents.

PEER provides a variety of services to the Legislature, including program evaluations, economy and efficiency reviews, financial audits, limited scope evaluations, fiscal notes, special investigations, briefings to individual legislators, testimony, and other governmental research and assistance. The Committee identifies inefficiency or ineffectiveness or a failure to accomplish legislative objectives, and makes recommendations for redefinition, redirection, redistribution and/or restructuring of Mississippi government. As directed by and subject to the prior approval of the PEER Committee, the Committee's professional staff executes audit and evaluation projects obtaining information and developing options for consideration by the Committee. The PEER Committee releases reports to the Legislature, Governor, Lieutenant Governor, and the agency examined.

The Committee assigns top priority to written requests from individual legislators and legislative committees. The Committee also considers PEER staff proposals and written requests from state officials and others.

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The Mississippi Legislature

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January 5, 2015

Honorable Phil Bryant, Governor
Honorable Tate Reeves, Lieutenant Governor
Honorable Philip Gunn, Speaker of the House
Members of the Mississippi State Legislature

On January 5, 2015, the PEER Committee authorized release of the report entitled **An Update on the Financial Soundness of the Mississippi Public Employees' Retirement System and Related Legal Issues: 2014.**

Nancy Adams Collins

Senator Nancy Adams Collins, Chair

This report does not recommend increased funding or additional staff.

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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.[*] 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.

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

- 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.+

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.

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

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

Introduction

Authority

MISS. CODE ANN. Section 25-11-101 (1972) directs the PEER Committee to:

> *. . . have performed random actuarial evaluations, as necessary, of the funds and expenses of the Public Employees' Retirement System and to make annual reports to the Legislature on the financial soundness of the system.*

The PEER Committee, utilizing its authority found in MISS. CODE ANN. Section 5-3-51 et seq. (1972), carried out the statutorily required review of the financial condition of the Public Employees' Retirement System (PERS). Actuarial reviews authorized by this section are discretionary.

Scope and Purpose

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.

Method

In conducting this review, PEER:

- reviewed financial reports of the Public Employees' Retirement System;
- reviewed actuarial reports and projections prepared for PERS;
- interviewed personnel of the Public Employees' Retirement System; and,
- reviewed significant case law from other jurisdictions rendered in 2014 that addresses employees' contractual rights in employment benefits.

Background

Most Mississippi public employees receive their retirement benefits from the Mississippi Public Employees' Retirement System. This system, dating from 1952, serves employees in state and local government, as well as educators in the K-12 and college levels of employment. MISS. CODE ANN. Section 25-11-101 (1972) provides, in part:

> *A retirement system is hereby established and placed under the management of the board of trustees for the purpose of providing retirement allowances and other benefits under the provisions of this article for officers and employees in the state service and their beneficiaries. . . .*

Following the serious recession of the latter part of the first decade of the 2000s, many persons became concerned about the financial soundness of PERS and raised questions regarding the possibility of major restructuring of eligibility rules and benefits for current and future system members. To address these concerns and questions, the PEER Committee produced Report #564 (*The Public Employees' Retirement System of Mississippi: A Review of Selected Issues Related to Financial Soundness)* in 2012. That report provides:

- background information on PERS and the programs it administers;
- detailed information on the composition of the PERS Board of Trustees; and,
- the legal basis for the state's provision of retirement benefits to public employees.

Report #564 also sets out an analysis of PERS's financial soundness and its investment and risk management practices. A full copy of Report #564 is available at PEER's website (www.peer.state.ms.us).

This 2014 report provides a concise overview of where the system currently stands financially and provides an update on recent legal actions involving states' attempts to modify retirement benefits for pension systems' members and retirees.

Update on Financial Soundness of PERS

PEER established in Report #564 that the term "financial soundness" should be defined not as a point-in-time comparison of assets and liabilities, but as a multi-faceted construct involving an understanding of the role of actuarial soundness in judging financial health, a broadly defined view of affordability that encompasses sustainability in light of all relevant environmental conditions, and an understanding of the role of risk and investment management in the long-term financial health of the system.

The PERS Board has adopted and implemented policies and procedures that allow it to address the major contributing areas to the plan's financial well-being and to carry out its fiduciary responsibilities to its active members and retirees. These policies and procedures fall into the following contributing areas:

- actuarial soundness and sustainability; and,
- risk and investment management.

This chapter will discuss each contributing area and highlight relevant activity and changes to PERS for the last fiscal year and future projections.

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.**

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.

The PERS system receives employee and employer contributions from seven sources:

- state agencies;
- state universities;

- public school districts;
- community and junior colleges;
- counties;
- municipalities; and,
- other political subdivisions (e. g., water or sewer utility districts).

For FY 2014, payroll from public school districts accounted for 37% of contributions, state agencies accounted for 19% of contributions, and the remaining payroll was received from the other five sources noted above.

The PERS Board, with assistance from its staff and other contractual advisors, endeavors to maintain the actuarial soundness of the plan by receiving quarterly updates concerning the performance of the system's assets and annual actuarial updates in conjunction with annual projections and biannual experience reports.

The accuracy of the assumptions used has an impact on the future projections of the plan. At present, the actuarial model[1] is assuming 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 2.40% over the last ten years and 0.02% over the last five years. The two largest payroll components, public school districts and state agencies, had declines of -1.05% and -1.16%, respectively, from FY 2013 to FY 2014 and have declined -4.31% and -5.40%, respectively, since June 30, 2009.

For the purposes of calculating PERS's accrued liabilities, the lower than projected salary increases reduced PERS's accrued liabilities approximately $252 million during Fiscal Year 2014. However, the smaller than anticipated salary increase also reduced the amount of employer contributions targeted for the reductions of the unfunded actuarial liability by approximately $33 million and the system's lower than expected payroll growth experience added approximately one year to the system's unfunded accrued liability amortization period. Although the smaller than projected salary increase has the affect of reducing the plan's future liabilities, the lower than expected growth also has negative impacts to the plan. Overall, this difference between projected and actual payroll warrants future monitoring through the system's biennial experience study.

PERS's independent actuary conducts an experience study every two fiscal years in which the assumptions used in the actuarial model are reviewed and modifications recommended

[1]PERS's actuarial model considers factors such as projected investment returns, payroll increases, inflation, retirement ages, mortality rates, marriage rate, and accrued leave to project future assets and liabilities of the system.

based on a study of actual trends and numbers compared to the model's assumptions. After the experience study as of June 30, 2012, PERS adopted in FY 2013 changes relating to salary scales used in the actuarial model. The actuary will perform an experience study as of June 30, 2014, and will present the study's results and recommended modifications to the PERS Board at its April 2015 meeting.

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.

To help address the volatility of the employer contribution rate, the PERS Board of Trustees adopted a funding policy in October 2012, modified in December 2013, that changed the employer contribution rate percentage from an annually calculated actuarial valuation to a fixed rate of 15.75% of annual compensation. The revised funding policy also targets an 80% funding level by 2042 while still reducing the plan's unfunded actuarial accrued liability. In addition to the effects listed above, PEER notes that this funding policy change should have the effect of creating more long-term sustainability within the PERS system.

As of June 30, 2014, PERS's anticipated accrued liability payment period[2] was 29.2 years, a decrease from 32.2 years as of June 30, 2013. PERS's independent actuarial advisor attributes the decline primarily to the recognition of investment gains in four out of the last five fiscal years in the actuarial value of assets. Actuarially smoothed gains and losses[3] are recognized over a five-year period. For FY 2014, the PERS system recognized gains and losses from FY 2010 through FY 2014 for a combined investment gain of approximately $1.1 billion.

The actuarial advisor also noted that the actuarial gains were

> *. . .offset by payroll growth less than expected, causing upward pressure on the amortization*

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[2]The *accrued liability payment period* is the estimated length of time under current actuarial assumptions that is required to pay the unfunded accrued liability. An *unfunded accrued liability* occurs when the total of present value of future benefits associated with prior years' service and the present value of future administrative costs is greater than the actuarial present value of the system's current assets.

[3]The actuarial value of PERS's investments is calculated on a five-year smoothing average in which gains and losses are recognized over five years.

period attributed to the unfunded accrued liability.

PEER notes that if payroll continues to lag behind the actuarial model assumptions, upward pressure may continue on the accrued liability payment period. Because the assumptions for payroll growth and pay increases are inversely related, any upward pressure on the accrued liability payment period may be offset, partially or totally, by positive actuarial experience related to pay increases that are less than those assumed.

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.

Risk management and investment management are the other two areas PEER has identified as major contributing factors of components of financial soundness. Risk management and investment management seek to 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.

Risk Management

As of June 30, 2014, the 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.

For FY 2014, the actuarial value of PERS's assets increased in relation to the actuarial value of its liabilities--from 57.7% to 61.0%. The relationship between these two valuations strengthened due to the effects of 2009 losses rolling off of the actuarial asset valuation and a strong 2014 investment return replacing it.

Projections provided by Cavanaugh Macdonald, the system's independent actuarial advisor, show the funding ratio moving to 64.07% for FY 2015 and to 109.7% as of 2042. The projections also estimate a funding level of 80.43% will be achieved in 2031. These projections show the originally adopted model's funding goals of an 80% minimum funding ratio in 2042 will be achieved much earlier.

For the projected information to be accurate, all actuarial assumptions used in the projection must be met exactly for all fiscal years forecasted. As past performance shows, this mark can be missed on both the high and low sides, creating variability from the model.

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.

For Fiscal Year 2014, the market value of PERS's system assets was approximately $24.9 billion, an increase of $3.2 billion from Fiscal Year 2013. The combined investment portfolio experienced a return of 18.6%.

The current actuarial model operates with a targeted investment return of 8% annually. During the last ten years, PERS's investment return on assets averaged 7.54%. Investment returns ranged from a -19.4% during FY 2009 to 25.4% during FY 2011. Historically, PERS's investment returns have averaged 8.32% during the last twenty years and 8.53% over the last twenty-five years. According to an October 2014 issue brief from the National Association of Retirement Administrators, the median public pension annualized investment ten-year return for the period ending June 30, 2014, was 7.3% and the twenty-five-year return was 8.8%. PERS's investment returns closely track the investment return experience of public pension funds nationwide. The volatility of the recent years' returns reinforces the principle of viewing investment returns over a long period and comparing long-term returns to investment return goals rather than focusing on a single year's returns or returns over a short period.

While a 2013 amendment to MISS. CODE ANN. §25-11-121 (1972) could allow for participation in riskier investment vehicles, PERS should be able to mitigate this risk through application of its asset allocation model and established risk management policies.

A 2013 amendment of MISS. CODE ANN. §25-11-121 (1972) clarified existing law to be more consistent with how the portfolio is managed today, to describe more accurately the manner in which certain functions are handled, to expand the range of investment options available to PERS's investment managers, and to make sure PERS's current investment strategy conforms to statute.

Some of these changes could potentially open PERS's plans up to increased levels of investment risk, but these changes must also be taken in context with other areas of PERS's investment management. PERS has developed investment risk mitigation policies that cover many areas of the investment landscape. Some of these include, but are not limited to, qualification standards for all investment managers and consultants, asset allocation modeling done by individual asset class, investment measurement service quarterly reviews, and periodic asset/liability studies. These tools are used by PERS staff and the PERS Board of Trustees to assess performance measures and risk-versus-return results.

The PERS Board of Trustees adopted an asset allocation model effective July 2013 to set investment level targets for the PERS investment portfolio.

PERS's investment consultant periodically performs an asset/liability allocation study that considers projected future liabilities of the system, expected risk, returns of various asset classes, and statutory investment restrictions. During Fiscal Year 2013, the PERS Board of Trustees adopted a new asset allocation model effective July 2013. The asset allocation model dictates the types of asset classes the PERS system will invest in and the overall weight of each investment area relative to the plan as a whole.

The PERS Board of Trustees and PERS staff use this model to mitigate investment risk by creating target performance levels for each asset class and reviewing, on a quarterly basis, the performance of each investment manager relative to their asset class's target performance level.

The exhibit below shows the actual 2014 investment allocation compared to the model.

Exhibit: PERS's Actual Asset Allocation Compared to Allocation Model, as of June 30, 2014

Year	U. S. Equity	Non-U.S. Equity	Debt Investments	Real Estate	Private Equity	Global Equity	Cash
Model	30%	22%	20%	10%	8%	9%	1%
2014	37%	23%	20%	9%	4%	6%	1%

SOURCE: PERS Comprehensive Annual Financial Report and PERS Investment Report as of June 30, 2014

It should also be noted that instances in which current investment levels are not in agreement with the model do not automatically constitute a cause for alarm or create the need for an immediate change in investment levels. The investment model represents targeted investment levels designed to prevent the investment portfolio from becoming too heavily weighted in a certain investment type. At times, market conditions may cause a prudent manager to call for slight departures from target goals. For these reasons, the PERS Board monitors investment performance, strategies, and weights throughout the year and manages the investment portfolio based on input from professional money managers, advisors, and PERS professional staff.

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 2007, the Legislature changed the PERS vesting period from four years to eight years. According to PERS staff, although no cost analysis was performed at that time, the common perception was that such a change would improve the funding ratio of the PERS system. Subsequent to the change, views regarding the change in the vesting period have modified.

The final report of the Governor's Public Employees' Retirement System Study Commission created by Governor Haley Barbour, issued in December 2011, recommended lowering the vesting period from eight years to four years. In response to this recommendation, inquiries from PERS employer groups, and in anticipation of legislation regarding this issue, the PERS Board requested that the PERS actuary perform a cost analysis as of June 30, 2013, of the impact on moving from an eight-year vesting period to a four-year vesting period. The PERS actuary concluded that moving from an eight-year vesting period to a four-year vesting period would have decreased the funding ratio by one-tenth of one percent.

Retirement plans have become a major tool for recruiting employees to state government. In the past, many considered retirement plans to be part of an employment package, but today they provide a method by which public sector employers can compete for staff in a competitive job market. While many positions in private sector employment may offer higher salaries, public sector employers can offer a pension program that offers their employees a means to a stable retirement income. Some private sector employers no longer offer such. In contemplating a change from eight years vesting to four years vesting, a factor to consider is the potential advantage of offering a shorter vesting period to help attract potential employees.

Curbing “Stacking” and “Spiking” Practices

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.”

“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[4]“ years for the purpose of increasing the member’s retirement benefits. 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.

MISS. CODE ANN. §25-11-103 (f) (1972) limits stacking and spiking by excluding any increase in annual salary or compensation of more than eight percent within twenty-four months of retirement. An exclusion allows increases over eight percent if the employer provides PERS with an affidavit stating that the increase was not granted on an agreement to retire and:

- satisfactory proof is presented to the PERS Board showing that the increase was the result of an actual change in the position held or services rendered; or,
- the salary increase was authorized by the State Personnel Board; or,
- the increase was the result of statutory enactment.

In 2013, the Legislature amended MISS. CODE ANN. Section 25-11-103 (k) (1972) to limit the definition of average compensation to:

- prospectively exclude the value of maintenance (e. g., employer-provided housing, utilities, meals) from earned compensation and to grandfather those who have maintenance reported to PERS as earned compensation;
- clarify that employer-paid health and life insurance premiums for an employee are not earned compensation, whether taxable or nontaxable to the employee;
- prospectively exclude performance-based incentive payments from earned compensation; and,

[4] Calculation of an individual’s retirement benefit is based on the highest four years of salary.

- clarify that in-kind benefits are not reportable to PERS as earned compensation.

According to PERS officials, PERS has not conducted an impact study of stacking and spiking. In order for PERS to make recommendations to the Legislature regarding stacking and spiking, additional information would be required to present a clearer understanding of the cost and pervasiveness of these practices.

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

In its 2012 report, which was updated in 2013, the PEER Committee provided information regarding possible legal risks associated with making changes in the current retirement system for retirees and current PERS members. Briefly, the 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.

PEER's 2012 report provided an in-depth analysis of how courts have applied these principles and further discussed instances wherein courts have chosen to apply different principles in cases involving modifications to state pension systems.

While the 2012 report notes that modifications to the PERS program for current members and retirees are fraught with legal risks, several states have taken the step toward modifying their programs for current employees and retirees, thereby accepting the risk of litigation. The following discusses recent actions and instances wherein states have litigated specific types of pension modifications for current members or retirees. These cases most often hinge on court interpretations of state constitutional provisions protecting contractual rights. Generally, these state pension modification efforts have focused on two areas of pension benefits:

- changing members' contribution rates, minimum years to retirement, or value of service credit; and,
- the calculation and availability of cost-of-living adjustments for retirees.

This chapter provides an overview of significant cases that have been rendered or filed since the 2012 and 2013 PEER reports on PERS.

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.

Several states have in recent years adopted changes in these areas (i. e., members' contribution rates, minimum years to retirement, or value of service credit) in an attempt to bolster the financial soundness of their pension plans. In several instances, employees or unions objected to the changes and sought judicial relief by asserting that the changes violated state and federal constitutional provisions protecting against the abrogation of contract rights. It appears that in the cases litigated, many changes have not been upheld and the contractual rights of employees and retirees have been upheld.

In this section, PEER has reported styles of cases only in instances wherein an appellate court has rendered a final decision or there is a trial decision that is final.

California

During 2014, several cases in California dealing with local retirement reform initiatives were litigated. These cases dealt with AB 197 and AB 340, which were two pension reform bills passed by the California General Assembly in 2012. Some of the more interesting reforms, including a provision that will allow for increased cost sharing by current employees arrived at through contract negotiation, will not go into effect until 2018.

This reform poses a distinct possibility of future litigation on that point, particularly if negotiated agreements result in increased employee contributions. The most recent litigation has dealt with controls on income "spiking" and on local referenda that impact pension management.

In *San Jose Police Officers' Association v. City of San Jose* (Superior Court for the County of Santa Clara, April 29, 2014), the association challenged provisions of the Sustainable Retirement and Compensation Act, a ballot initiative that amended the San Jose City Charter on June 4, 2012. This initiative contained many provisions dealing with definitions whose constitutionality was affirmed. However, as to existing employees and retirees, provisions dealing with increased contributions and cost-of-living adjustments were held to violate the California constitution's contract clause. The city is appealing the lower court decision.

Similarly, a case challenging the provisions of AB 197, coming out of Alameda County and Contra Costa County, dealt with call-back pay and other "spiking" strategies. A Superior Court decision from 2014 found that while generally such reforms were constitutional, in some cases, existing employees could argue that they had an implied contractual right to claim such compensation as part of their retirement compensation. Such determinations would have to be based on a case-by-case determination by the local retirement board. See *Alameda County Deputy Sheriff's Association v. Alameda County Employees' Retirement Association* (Superior Court for Alameda County, May 12, 2014). Future appeals of these decisions are likely to impact the entire California pension reform process.

Illinois

While not addressing pension benefits, a recent Illinois decision could impact any pension reform. In 2012, Illinois passed legislation that would reduce state contributions to pay group health insurance premiums for retirees. In *Kanerva v. Weems*, 303 Ill Dec 107, 13 N.E. 3d 1228 (2014), the Illinois Supreme Court ruled that medical benefits paid to retirees were protected by Illinois's constitutional provision specifically protecting benefits extended to members of the state's pension system. This case's ruling may make ongoing litigation in Illinois dealing with pension reform difficult for the state to win. Pension reform in Illinois reduces benefits to be paid to members, but also reduces employee contributions to their retirement.

Louisiana

In December 2013, the Louisiana Court of Appeals for the Fourth Circuit ruled in *New Orleans Fire Fighters Pension & Relief Fund v. City of New Orleans*, 2013-CA-0873, that it was proper for a trial court to direct the city to fund certain pensions in accordance with a statutory requirement even though such would have a deleterious impact on the city's budget. See *New Orleans Fire Fighters Pension & Relief Fund v. City of New Orleans,* 131 So. 2d 412 9La App, 2013), cert. den'd. 135 So. 3d. 623, 138 So. 3d. 616 (La, 2014).

After the Louisiana Supreme Court denied the city's petition for a writ of certiorari, the United States Supreme Court denied certiorari on October 6, 2014, See 574 U.S. __ (2014).

New Hampshire

On December 10, 2014, the New Hampshire Supreme Court ruled in *Professional Firefighters of New Hampshire v. State* (No. 2013-669), *December 10, 2014,* that current members of the state's retirement system do not have a protected contractual interest in a fixed employee contribution rate. In this case, the court reviewed legislation that increased active members' contributions to the retirement system. New Hampshire joins Florida and Michigan in so ruling. In this case, the court specifically rejected the principles of the so-called California rule, which Mississippi applies, that require offsetting increases in benefits whenever the state imposes additional burdens on a member of the retirement system.

Ohio (Cincinnati Municipal Retirement System)

The City of Cincinnati made several changes in its municipal pension system. These included an increase in active employee contributions, changes in the age at which an employee is eligible for retirement, and changes in creditable service calculations. An active employee member brought suit against the city in the United States District Court for the Southern District of Ohio in which the employee alleges impermissible impairment of contract. Trial was set for the end of October 2013. PEER has found no evidence of a ruling in the case as yet. See *Sunyak v. City of Cincinnati*, United States District Court, Southern District Ohio, 2013. Recent articles from 2014 state that efforts are being made to settle the lawsuit. Settlement offers from the city include a requirement that retirees accept a cap on future COLAs in return for the city backing away from other system changes.

Rhode Island

Rhode Island made major changes in its pension program for current members and retirees. Late in 2012, a Rhode Island court found that there exists an implied contract between members of a retirement system and the state that cannot be substantially impaired when the active member has become vested. The result of this decision was to imperil major pension changes in the state that affected retirement age, calculation of years of service, and final average salary. Employees were also moved to hybrid plans. Following the court's decision in 2012, the trial judge submitted the matter to a mediator. As of this date, no report has been produced showing a possible resolution of these claims. See *Rhode Island Public Employees Retiree Coalition v. Chaffee*, Rhode Island Superior Court, 2012. Efforts at mediation have failed and as of this writing, the case has not gone to trial.

Texas (Fort Worth Municipal Retirement System)

In August 2013, a state court judge ruled that certain changes to a Fort Worth municipal retirement system were constitutional, as they affected only future accruals of benefits. The changes included modifying the multiplier for future years of service, raising the number of years used to calculate salary for retirement purposes, and removing overtime from the calculation of compensation.

At this time, a federal judge in Fort Worth has lifted a stay of proceedings in a similar federal case challenging these changes. As of 2014, the parties were in discovery.

States' Modifications of Cost-of-Living Adjustments

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

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. Many pension reformers have seen COLA reduction or elimination as a potential avenue for reducing pension system costs, thereby bolstering the financial soundness of such systems. Retirees and active employees often take the position that the COLA is a contractual right that may not be impaired. The following discusses recent case law on COLA modification or elimination.

Arizona

In 2013, Arizona's changes to its COLA benefits were litigated. On February 20, 2014, the Arizona Supreme Court rendered a decision in *Fields v. The Elected Officials Retirement Plan*, 320 P. 3d. 1160 (Ariz, 2014). The *Fields* petitioners argued a contractual right to their COLAs, as they were calculated based on the retirement plan's return on investment. The changes enacted reduced the retiree benefits to a 2.47% increase rather than the anticipated 4% increase under the return on investment method used earlier. The retirees received no increases in 2012 or 2013.

The Arizona Supreme Court agreed and struck down the pension reforms as they were applied to the retired judges, asserting that such benefit increases were a contractual right protected under the Arizona constitution. A similar case in which active member plaintiffs challenged the change in the COLA formula was stayed pending the resolution of the *Fields* case.

Colorado

2014 saw a conclusion to Colorado COLA litigation first reported in the 2012 PEER report on PERS. In 2012, PEER reported that Colorado had adopted a legislative modification of its COLA for state employees. Following the change, retirees challenged the constitutionality of the change, arguing that they were contractually entitled to have their COLAs calculated using the formula in effect at the time of their retirement, rather than the fixed COLA that was offered as a substitute.

At trial, the court rendered summary judgment for the state without conducting contracts clause analysis. This decision was reversed and remanded by an appeals court that directed the lower court to conduct the necessary analysis to determine whether there has been a substantial impairment of a contract and if there is a reasonable basis for such. Not satisfied with the result, the plaintiffs filed for a writ of certiorari with the Colorado Supreme Court under which they may argue that their contractual rights have been impaired by the COLA change. See *Justus v. State of Colorado* (writ granted August 5, 2013).

In October 2014, the Colorado Supreme Court concurred with the trial court that petitioners had no contractual rights in a COLA calculated using the method or formula in place at the time of their retirement. In reviewing the history of COLAs in Colorado, the court noted that the Legislature had modified the COLA calculation formula many times over the years. Therefore, the petitioners could not reasonably conclude that they had a contractual right to a COLA calculated on the formula in use at the time they retired. See *Justus v. State of Colorado* (2014 CO 75, Decided, October 20, 2014).

Maine

In 2011, the Maine Legislature placed a three-year freeze on statutory cost-of-living adjustments granted to state retirees. Plaintiff retirees brought suit against the state alleging contracts clause violations in that the reductions impair their contracts with the state. The case was filed in the United States District Court for Maine. On June 23, 2013, the court dismissed the case, citing failure on the part of the plaintiffs to show that there was in fact a contract between themselves and the state of Maine. See *Maine Association of Retirees v. Board of Trustees* (United States District Court for Maine, 2013). In 2014, the United States Court of Appeals for the First Circuit affirmed the decision of the district court in this case. In *Maine Ass'n of Retirees v. Board of Trustees*, 758 F. 3d. 23 (1 st. Cir, 2014), the First Circuit concluded that the retirees could not conclusively argue and the court could not unequivocally conclude that the Maine Legislature intended to bind the state contractually to provide retirees with COLA benefits calculated under the pre-2011 amendments. The court noted that it must be able to conclude unequivocally that the COLA calculation formula for which the petitioners argued was clearly a part of the contract. A review of the statutes creating the pension benefits did not show an intention to make COLAs one of the benefits Maine guarantees to its public employees.

New Jersey

In 2014, a New Jersey appellate court held unconstitutional a 2011 statute that suspended COLAs for thousands of retired public employees in New Jersey. In *Berg v. Christie,* 93 A. 3d. 397 (N.J. Super, 2014), the appellate division of the Superior Court found that New Jersey's non-forfeitable rights statute creates a contractual right to a COLA that cannot be abridged under the state's constitution. Of particular interest was the court's observation that the assertion that changes needed to be made to protect the retirement plan's financial integrity was not enough to justify the elimination of a COLA when much of the pension system's problems could be attributable to the state's missing its payments to the system needed to maintain the system's health and viability.

While not addressing COLAs, there is recent litigation in New Jersey against the Governor alleging that the state's decision not to pay the entire employer contribution portion to the retirement systems violates state constitutional requirements to make payments annually to fund the state pension systems.

Washington

COLA litigation began in Washington in 2011. In that year, Washington eliminated the COLA for retirees in two of the state's older retirement systems. Neither system has taken in new members since 1977. At issue is whether the Legislature can repeal the COLA when the legislation authorizing it contained a clause reserving the Legislature's right to abolish or modify the COLAs. At the trial level, the plaintiff retirees prevailed, successfully arguing that the elimination constituted an abrogation of contractual rights. The Washington Supreme Court heard oral arguments in the case on October 25, 2013. See *Washington Federation of State Employees v. State of Washington* (Thurston County Superior Court, 2012)

In 2014, the Washington Supreme Court rendered its decision reversing the lower court decision. In *Washington Federation of State Employees v. Department of Retirement Systems,* 332 P. 3d 439 (Wash, 2014), the Washington Supreme Court concluded that an expressed reservation of a right to repeal or modify a COLA benefit found in the statute that created the COLA benefit clearly defeated the petitioners' argument that they had a contractual right in COLAs calculated to grow at a fixed rate in force and effect prior to 2011.

Oregon

In 2013, Oregon passed legislation that would reduce annual COLAs from two percent to a lesser rolling amount. Retiree petitioners challenged the constitutionality of these changes in *Moro et al. v. State of Oregon et al.*, SO61452, Oregon Supreme Court (filed July 1, 2013). Four other cases challenging the COLA changes were consolidated with this case.

Under Oregon procedure, a special master was appointed to take testimony in the matter. The Special Master submitted his report on April 30, 2014, detailing the amount of benefit reduction for the petitioners and the amount of saved public expense, as well as information regarding the necessity of purpose behind the legislation.

Oral arguments were conducted before the Oregon Supreme Court on October 14, 2014. During the arguments, the retirees told the seven assembled justices that over the past forty years, the Oregon Supreme Court has engaged in a clear pattern of decisions as to what constitutes a statutory contractual agreement--which is what PERS is to its recipients--and what can and cannot be added or taken away. A decision is expected sometime in 2015.

This case also addresses the Oregon Legislature's decision to eliminate a subsidy given to Oregon retirees living in other jurisdictions. Because other jurisdictions impose an income tax on retirement benefits (Oregon does not), the retirement systems have been paying out-of-state retirees additional funds to defray the costs of paying the income tax. Petitioners allege that this action also violated the contractual rights of retirees.

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.

Cases in California, Rhode Island, and Oregon will be of significance, as their courts will be addressing major attempts to change the pension systems upon which public employees rely. California cases face the appeals process, although the two cases discussed will impact the future of pension reform in that state. Rhode Island's attempts at negotiated changes in retirement involving current members appear to have failed and are headed for court review. While the most significant issue before the Oregon Supreme Court deals with COLAs, there is one non-COLA benefit in dispute, the repeal of a tax offset for persons receiving Oregon retirement living in states that tax pension benefits, that also merits continued attention.

The California cases, particularly the San Jose case dealing with increased contributions for current employees, will be of great importance to all states employing the California Rule. 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.[5]

COLA litigation of late has shown a marked tendency to favor state attempts to control or modify COLA calculations. Cases from Colorado, Washington, and Maine have all concluded that retiree plaintiffs had no contractual right to have a pension COLA paid based on a particular formula in use at the time they retired. In these states, it must be noted, the legislature had either repeatedly changed its methods several times over the years (e. g., Colorado), specifically reserved in law the right to amend or repeal the COLA in the very provision of law that created the COLA (e. g., Washington), or made no clear guarantee in law of a COLA to be calculated in a particular manner as being a contractual benefit (e. g., Maine).

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.

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

Conclusion

PERS has a prudent and disciplined process that relies on expert actuarial guidance built upon reasonable assumptions and targets for portfolio growth. 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.

As noted in PEER's 2012 report, 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.

This review shows that PERS has a prudent and disciplined process that relies on expert actuarial guidance built upon reasonable assumptions and targets for portfolio growth. 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. Nothing in PEER's fieldwork indicates that the system is facing an imminent collapse that would be necessary to justify modifications to current members' benefits.

PEER notes that in other jurisdictions, legislatures facing conditions arguably far more dire than those in Mississippi have taken steps to modify the contributions, retirement age, or other benefits given to current system members and have made modifications to the COLAs of retirees. The legality of such changes is linked to the degree of protection these states confer upon the contractual rights of their system members and retirees. Generally, states such as Mississippi that employ the so-called California Rule will find it quite difficult to modify benefits, either past or future, of members. Litigation in California, Rhode Island, and Oregon and COLA litigation in Washington should be closely tracked, as it will show the extent to which any change in California Rule states could be considered acceptable.

PERS of MISSISSIPPI

Providing Benefits for Life

December 22, 2014

Max K. Arinder, PhD.
Executive Director
Performance Evaluation and Expenditure Review
Woolfolk Building, Suite 301-A
501 North West St.
Jackson, MS 39201

Dear Dr. Arinder:

Thank you for the opportunity to review the draft of the PEER Report titled *An Update on the Financial Soundness of the Mississippi Public Employees' Retirement System and Related Legal Issues: 2014*. As you acknowledge in the Report, the PERS Board of Trustees has a prudent and disciplined process in place that relies on expert actuarial guidance built upon reasonable assumptions and targets for portfolio growth. This process, in conjunction with competent, prudent management, should address the System's financial sustainability. Moreover, we agree that sound financial management is a long-term commitment to a disciplined, prudent process of managing for risk.

We acknowledge and appreciate the diligence and effort you and your staff expended in compiling this report, and we respect the professional manner in which the review was conducted. Please contact me at 601-359-2241 if you need further information. Thank you.

Sincerely,

Pat Robertson
Executive Director

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