#601

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

Report to
the Mississippi Legislature

The Public Employees' Retirement System: 2015 Update on Financial Soundness, Delays in Application Processing, and Legal Issues

December 15, 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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December 15, 2015

Honorable Phil Bryant, Governor
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On December 15, 2015, the PEER Committee authorized release of the report entitled **The Public Employees' Retirement System: 2015 Update on Financial Soundness, Delays in Application Processing, and Legal Issues.**

Representative Becky Currie, Chair

This report does not recommend increased funding or additional staff.

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The Public Employees' Retirement System: 2015 Update on Financial Soundness, Delays in Application Processing, and Legal Issues

Executive Summary

Introduction

This report includes an update on the financial performance of Mississippi's Public Employees' Retirement System (PERS) and projected funding levels, as well as other issues of note for PERS.

This report also includes a review of the causes and circumstances that could have led to recent delays in the processing of PERS members' applications for service retirement benefits.

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 2014 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.

Update: PERS's Actuarial Soundness

As a result of the most recent experience study conducted by the independent actuarial firm Cavanaugh Macdonald Consulting, LLC, for the four-year period ended June 30, 2014, the PERS Board adopted at its April 2015 board meeting changes to the actuarial assumptions effective July 1, 2015, for future years and elected to use the new assumptions in the

calculation of system liabilities for FY 2015. The cumulative effect of these changes for the FY 2015 valuation was a one-time increase to the unfunded actuarial accrued liability of $1.8 billion.

Update: PERS's Sustainability

The current PERS funding policy is designed to address the past volatility of employer contribution rates within the 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 will have the effect of creating more long-term sustainability within the 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.

Update: PERS's Risk Management

As of June 30, 2015, the PERS funding ratio was 60.4%, a decrease from 61.0% as of June 30, 2014. This reduction in the funding ratio is due to the one-time impact of the adoption of actuarial assumption changes recommended in light of the results of the most recent four-year experience study for the period ending June 30, 2014. Actuarial projections provided by Cavanaugh Macdonald show that the PERS Board's originally adopted model's funding goals of an 80% minimum funding ratio in 2042 will still be achieved.

Update: PERS's Investment Management

For Fiscal Year 2015, the PERS plan's combined investment portfolio experienced a return of 3.5% and the market value of the system's assets was approximately $24.8 billion.

For Fiscal Year 2015, the PERS Board of Trustees continued to adhere to the asset allocation model put in place in July 2013. This model continues to set investment level targets for the PERS investment portfolio.

Other Issues of Note for PERS

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. As it did in FY 2015, the PERS Board is suggesting that the Legislature return the vesting period to four years.

For Fiscal Year 2015, all employers participating in the PERS plan that issue Generally Accepted Accounting Principles (GAAP) financial statements must comply with the requirements of Governmental Accounting Standards Board Statement No. 68. While the changes outlined in Statement No. 68 will affect the presentation of participating employers' financial statements, the actual financial position of participating employers will not be affected.

Recent Delays in the Processing of PERS Members' Applications for Service Retirement

Although PERS recommends that members file for benefits ninety days in advance of their anticipated retirement date, the PERS staff notes that in many cases, and under normal operating conditions, the processing of applications for service retirement benefits may be completed in as short a time as thirty days.

However, from March 2015 through September 2015, the Public Employees' Retirement System experienced delays in the processing of applications for service retirement benefits. According to PERS estimates, approximately 2,000 applications from that period were affected, experiencing processing times that did not allow for the completion of the applications within the ninety-day period recommended by PERS.

According to PERS staff, as of September 15, 2015, all of the delayed applications for service retirement benefits had been processed. All applicants who completed the retirement process by submitting the required documents have been added to the retirement payroll (with payments retroactive to the initially stated date of retirement).

The recent delays in PERS's processing of applications for service retirement benefits may be attributed to a combination of three factors noted below:

- *Transition to a new pension administration system*--In July 2015, PERS transitioned from its old pension administration system, Genesis, to its new system--the Mississippi Automated Retirement System (MARS). PERS received notification in early 2004 that the company responsible for providing technical support of the Genesis system would discontinue support in 2009. PERS began exploring options to replace or upgrade the Genesis system and issued a request for proposals in May 2007.

  Due to the bankruptcy of PERS's original choice of service provider, in addition to other delays, the development and implementation of MARS was not initiated until after Genesis no longer was receiving technical support (in 2009).

PERS did not begin using MARS to process applications for service retirement benefits until July 2015.

- *Employee turnover in key positions*--The loss of institutional knowledge and experienced workers in both the service retirement and management information systems departments could have contributed to the recent delays in the processing of members' applications for service retirement benefits.
- *Annual peak volume of applications*--PERS's processing delays were exacerbated by their occurrence during a period during which the system traditionally receives its highest volume of service retirement applications each year.

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

PEER's 2012 report (*The Public Employees' Retirement System of Mississippi: A Review of Selected Issues Related to Financial Soundness* [Report #564]) 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.

Since the 2014 PEER update on PERS, 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, and detailed in this report, the contractual rights of employees and retirees have generally been upheld. Some jurisdictions take a more restrictive view of contractual rights than do others.

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

While some cases that PEER has reported in the past few years have allowed modification of benefits for system members and

employees, the trend seems to favor protecting the benefits of employees. At this point, even COLAs are more likely to be protected when retirees can show that law or regulations created a reasonable expectation that a certain COLA would be payable.

PEER notes that although cases from foreign jurisdictions might not be of particular significance when assessing the constitutionality of possible changes to Mississippi's PERS, the Committee would suggest that cases from so-called "California Rule" jurisdictions are of particular interest to policymakers, as our state does apply this rule when reviewing claims of constitutionality of pension plan changes.

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The Public Employees' Retirement System: 2015 Update on Financial Soundness, Delays in Application Processing, and Legal Issues

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, under 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 2015 report includes an update on the financial performance of the system and projected funding levels, as well as other issues of note for PERS.

This report also includes a review of the causes and circumstances that could have led to recent delays in the processing of PERS members' applications for service retirement benefits.

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 2014 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;
- reviewed investment assessments prepared for PERS;
- reviewed documents related to the selection and implementation of the pension administration system;
- interviewed personnel of the Public Employees' Retirement System; and,
- reviewed significant case law from other jurisdictions rendered in 2015 that addresses employees' contractual rights in employment benefits.

Background

The majority of Mississippi public employees and/or their beneficiaries receive their retirement benefits from the Mississippi Public Employees' Retirement System.[1] 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 provided:

- 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 2015 report provides a concise overview of where the system currently stands financially, looks into the recent delays in processing of applications for service retirement benefits, and provides an update on recent legal actions involving states' attempts to modify retirement benefits for pension systems' members and retirees.

[1]Employees of state government, public schools, universities, community colleges, municipalities, counties, the Legislature, highway patrol, and other political subdivisions are members of PERS unless their employers have elected not to participate in the PERS plan or their position is excluded under the law (e. g., a county constable or employee of a city that has not elected to be a part of PERS).

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 of these areas 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

As a result of the most recent experience study conducted by the independent actuarial firm Cavanaugh Macdonald Consulting, LLC, for the four-year period ended June 30, 2014, the PERS Board adopted at its April 2015 board meeting changes to the actuarial assumptions effective July 1, 2015, for future years and elected to use the new assumptions in the calculation of system liabilities for FY 2015. The cumulative effect of these changes for the FY 2015 valuation was a one-time increase to the unfunded actuarial accrued liability of $1.8 billion.

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.

As a result of the most recent experience study conducted by the independent actuarial firm Cavanaugh Macdonald Consulting, LLC, for the four-year period ended June 30, 2014, the PERS Board adopted at its April 2015 board meeting changes to the actuarial assumptions effective July 1, 2015, for future years and elected to use the new assumptions in the calculation of system liabilities for Fiscal Year 2015. The cumulative effect of these changes for the FY 2015 valuation was a one-time increase to the plan's unfunded actuarial accrued liability of $1.8 billion.

The adopted changes affected both the economic and demographic assumptions of the plan.

Economic Assumptions

The economic assumptions of the model seek to explain the overall environment in which the plan will operate and estimate the broad effects on the plan. The PERS Board reduced the price inflation, investment return, and wage inflation actuarial assumptions by 0.50%, 0.25%, and 0.50%, respectively.

The economic assumptions of the model seek to explain the overall environment in which the plan will operate and estimate the broad effects on the plan. The PERS Board adopted changes to price inflation, investment returns,[2] and wage inflation. Exhibit 1, below, shows a breakdown of these changes.

Exhibit 1: PERS's Economic Assumption Changes Effective July 1, 2015, and for Future Years

Assumption	FY 2016 and Future Years**	Most Recent Rate Prior to FY 2016
Price Inflation	3.00%	3.50%
Investment Return*	7.75%	8.00%
Wage Inflation	3.75%	4.25%

*Net of investment expense.
**The revised economic assumptions were also used in the valuation of system liabilities for FY 2015.

SOURCE: *State of Mississippi Retirement Systems Experience Investigation for the Four-Year Period Ending June 30, 2014*, Cavanaugh Macdonald Consulting LLC.

[2]The investment return assumption is reported net of investment expense (i. e., expenses and fees charged by PERS's hired investment managers).

Price Inflation

Based on a recommendation from its independent actuarial advisor Cavanaugh Macdonald, the PERS Board approved at its April 2015 board meeting an adjustment in the price inflation assumption from 3.50% to 3.00%, effective for FY 2016 and future years. The purpose of the price inflation assumption is an attempt to address the effect that inflation has on the cost of living over time. In other words, this assumption tries to quantify exactly how much more it will cost to live in the future than it does today.

In assessing the recommendation for price inflation, PERS's independent actuarial advisors considered several factors, including historical rates of the U. S. Department of Labor's Consumer Price Index, U. S. City Average, All Urban Consumers; yields of U. S. Treasury Inflation Protected Securities; and the Social Security Administration's old age, survivor and disability insurance trustee reports. Based on the factors considered above, which showed lower inflation growth, the PERS Board accepted the recommendation made by Cavanaugh Macdonald to lower the price inflation assumption of the plan from 3.50% to 3.00%.

The assumption for price inflation is important because it is considered in both the investment return and wage inflation assumptions. See the following sections for discussion of both of these assumptions.

Investment Return

Based on a recommendation from its independent actuarial advisor, the PERS Board approved at its April 2015 board meeting an adjustment in the investment return assumption from 8.00% to 7.75%, effective for FY 2016 and future years. The investment return assumption change is the largest contributor to the increase in PERS's unfunded accrued actuarial liabilities and represents a more conservative estimate of the future performance of the plan.

The PERS Board also elected to use the lower investment return assumption in the FY 2015 calculation of the system's future liabilities, which contributed to the increase in the system's unfunded accrued actuarial liabilities and represents the assumptions that will be used by the PERS system in future years.

The investment return assumption is used in the actuarial model to project the investment performance of the assets in the plan (i. e., what rate of return will current and future investments earn in the future) and to assign the rate at which expected benefits for active, inactive, and retired members will

be discounted to the present,[3] which is important in the calculation of the system's unfunded actuarial accrued liability percentage.

The investment return assumption is the sum of the real investment rate of return assumption[4] and the price inflation assumption. When considering PERS's real investment rate of return assumption, the PERS Board considers the results of the actuarial advisor's forward-looking modeling system (calculations of estimated future investment returns of current and future investments) that is guided by the current market assumptions of PERS's hired investment consultants and PERS's asset allocation model (see page 12 for a discussion of PERS's asset allocation model) that is set by the PERS Board. In addition to the forward-looking modeling system, the PERS Board considers the rate of return investment assumptions of other state and local pension systems in the United States.

The most recent results of the forward-looking modeling system and consideration of other state and local pensions systems' projected rate of returns yielded a median real investment rate of return of 4.90%. In April 2015, the PERS Board increased the real investment rate of return from 4.5% to 4.75%, which remains below the projected real investment rate of return of 4.90% and demonstrates a conservative approach to future earnings projections. The new real investment rate of return (4.75%) combined with the revised price inflation rate (3.0%) results in the projected investment rate of return of 7.75%.

PERS's revised projected investment rate of return of 7.75% is reasonable when compared to other state and local pensions' projected investment rate of return. According to information from the Public Funds Survey[5] dated October 2015, overall projected investment rates of return have trended downward over approximately the last fifteen years, with the median projected investment rate of return now at 7.66%. The most commonly used ranges of projected rates of return are between greater than 7.00%-7.50% and greater than 7.50% to less than 8.00%, representing 34% and 29% of the funds respectively.

The PERS Board and its independent actuarial advisor plan to continue to monitor the investment return assumption in future years in an effort to ensure that the investment return assumption accurately reflects market conditions and PERS's investment allocation model.

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[3]Given the effect of price inflation discussed above, a dollar is presently worth more than it will be worth in future years. Discounting is the method used to determine how much future contribution and benefit payments are worth today.

[4]The *real investment rate of return* is the return earned on investments after the effects of price inflation have been removed.

[5]The Public Funds Survey is an online compendium of key characteristics of 126 of the nation's largest public retirement systems. The survey is sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement.

Wage Inflation

Based on the recommendation of its independent actuarial advisor, the PERS Board, at its April 2015 board meeting, reduced the projected wage inflation rate from 4.25% to 3.75%.

The wage inflation assumption of the actuarial model accounts for projected salary growth over time. It is made up of two parts: the inflation component, which will be discussed in this section, and merit increases, which will be described in the Demographic Assumptions section.

The inflation component is comprised of the impact of inflation and the real rate of wage inflation,[6] which seeks to account for the overall increases in the value of labor over time.

PERS's independent actuarial advisors considered both historical information and future projections in its assessment of the real rate of wage inflation. According to the historical information, real rates of wage growth have been 0.43% and 0.64% for the last ten and fifty years, respectively. Future projections of the Social Security Administration include a real rate of wage growth of approximately 1.12%.

In light of these two sources, PERS's independent actuarial advisor recommended holding the real rate of wage growth at 0.75%. The PERS Board agreed with the advisor's recommendation and when combined with the 0.5% reduction in price inflations, the wage inflation rate decreased from 4.25% to 3.75%.

Demographic Assumptions

The demographic assumptions of the model seek to explain the effects of retirements (service and disability), withdrawals, mortality, and salary increases on the plan. The demographic assumption levels are based on subsets of the plan members, grouped by age, gender, and years of service.

The purpose of a demographic experience study is to compare what actually happened to the membership of the plan during the evaluation period (the four-year period ended June 30, 2014) with what was expected to happen based on the assumptions used in the most recent actuarial valuations.

Detailed tabulations by age, gender, and years of service are performed for all active and retired members. If actual experience does not follow the expected results, then new assumptions are recommended to better align PERS's assumptions with actual experience.

For the PERS plan, the following demographic assumptions were used and evaluated:

- rates of withdrawal;

[6]The *real rate of wage inflation* is the actual rate of inflation wages experience after the effects of price inflation are removed.

- pre-retirement mortality;
- rates of disability retirement;
- rates of service retirement;
- post-retirement mortality; and,
- rates of salary increase.

Subsequent to the experience study for the period ending June 30, 2014, the PERS Board adopted changes to all of its demographic assumptions. A full version of the actuarial valuation may be found on the PERS website.[7]

As noted previously, each demographic assumption's values may be striated by age, gender, and years of service. In an effort to provide an example of these changes, PEER elected to discuss the changes made to the rate of the salary increase actuarial assumption, which is under the control of the employer to a certain extent, whereas the other assumptions are not.

As noted above, the PERS Board reduced the rates of salary increase from 4.25% to 3.75%. The rate of salary increase assumption is the estimate of the amount that the wages of the PERS membership will increase annually in future years. This rate impacts the amount of funds available for investment and for meeting future system liabilities and also impacts the calculation of the amount of future system liabilities.

Over the last ten years, PERS's average annual payroll increase was below the projected 3.75% rate of salary increase. From FY 2006 through FY 2015, the average annual payroll increase was 2.16% and during the last five fiscal years (FY 2011–FY 2015), the average annual payroll increase was 0.5%.

For FY 2015 alone, PERS experienced salary growth of 1.20%, mostly due to the approximately 2.93% increase in salaries to public school teachers and an approximately 1.50% increase in salaries to county and local employees. For FY 2015, salaries of employees of state agencies, which represented approximately 18% of PERS-covered salaries, experienced a reduction of 0.93% for FY 2015.

In the PEER report *An Update on the Financial Soundness of the Mississippi Public Employees' Retirement System and Related Legal Issues: 2014* (Report #591, January 5, 2015), the Committee noted that PERS actuaries stated that payroll growth that is less than expected can cause upward pressure on the amortization period attributed to the unfunded accrued liability. Because the assumptions for payroll growth and pay increases are inversely related, any upward pressure on the accrued liability payment period may be offset, either partially

[7] http://www.pers.ms.gov/Content/ActuarialValuationReport/PERS_Experience_Investigation_Report_2014.pdf

or totally, by positive actuarial experience related to pay increases that are less than those assumed.

While the PERS Board adopted changes that help PERS's actual experience to align more closely with actuarial assumptions, continued analysis of this issue is warranted.

Sustainability

The current PERS funding policy is designed to address the past volatility of employer contribution rates within the 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 will have the effect of creating more long-term sustainability within the system.

To help address the past 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 system.

As of June 30, 2015, PERS's anticipated accrued liability payment period[8] was 33.9 years, an increase from 29.2 years as of June 30, 2014. PERS's independent actuarial advisor attributes the increase primarily to the recognition of changes in the actuarial assumptions following the experience study ending June 30, 2014. In addition to these effects, the funding policy will have the effect of creating more long-term sustainability within the system. (See page 4 for a discussion of changes in actuarial assumptions.)

PERS's independent actuarial advisors also note that the increase was slightly offset by the recognition of gains in three of the last five fiscal years in the actuarial valuation of assets. By using the accepted practice of actuarial value of assets, PERS recognizes investment gains and losses[9] over a five-year period in order to calculate an anticipated accrued liability payment period and a funded accrued liability percentage based on a

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[8]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.

[9]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.

five-year period rather than on one year that could result in large fluctuations of these figures. In FY 2015, the PERS system recognized gains of approximately $841 million from FY 2011 through FY 2015.

Without recognition of the actuarial assumption changes, the anticipated accrued liability payment period would have decreased from 29.2 years to 27.2 years. The adoption of the changes in actuarial assumptions created a one-time impact to the unfunded actuarial accrued liabilities of approximately $1.8 billion, mostly driven by the change in the investment return assumption.

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, 2015, the PERS funding ratio was 60.4%, a decrease from 61.0% as of June 30, 2014. This reduction in the funding ratio is due to the one-time impact of the adoption of actuarial assumption changes recommended in light of the results of the most recent four-year experience study for the period ending June 30, 2014. Actuarial projections provided by Cavanaugh Macdonald show that the PERS Board's originally adopted model's funding goals of an 80% minimum funding ratio in 2042 will still be achieved.

For FY 2015, the actuarial value of PERS's assets decreased in relation to the actuarial value of its liabilities--from 61.0% to 60.4%. The relationship between these two valuations weakened due to the effects of the FY 2015 changes in the actuarial assumptions, adopted from recommendations of the most recent four-year experience study for the period ending June 30, 2014. The actuarial gain on investments for FY 2015 was 12.2%, which represents the actuarial smoothing of gains and losses for the period of FY 2011 through FY 2015.

FY 2015 projections provided by Cavanaugh Macdonald show the funding ratio of the plan reaching 80.6% by 2042, as compared to 109.7% as reported for FY 2014. This difference is also primarily due to the adoption of changes to the actuarial assumptions. Even with these changes, the projections show

that the PERS Board's originally adopted model's funding goals of an 80% minimum funding ratio in 2042 will still be achieved.

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 2015, the PERS plan's combined investment portfolio experienced a return of 3.5% and the market value of the system's assets was approximately $24.8 billion.

For Fiscal Year 2015, the PERS plan's[10] combined investment portfolio experienced a return of approximately 3.5% and the market value of the PERS plan's system assets was approximately $24.8 billion. The current actuarial model operates with a targeted investment return of 7.75% annually. During the last ten years, PERS's investment return on assets averaged 6.90%. Investment returns ranged from a negative 19.4% during FY 2009 to 25.4% during FY 2011. Historically, PERS's investment returns have averaged 7.65% during the last twenty years and 8.25% over the last twenty-five years.

According to a May 2015 issue brief from the National Association of Retirement Administrators (NASRA), the median public pension annualized investment ten-year return for the period ending December 31, 2014, was 6.5% and the twenty-five-year return was 8.5%.[11] PERS's investment returns have exceeded the median for other public pension plans over the last ten years and closely track the investment return experience of public pension funds over the last twenty-five years. 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.

For Fiscal Year 2015, the PERS Board of Trustees continued to adhere to the asset allocation model put in place in July 2013. This model continues to set investment level targets for the PERS investment portfolio.

PERS's independent actuarial advisor 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. For Fiscal Year

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[10]The *PERS plan* refers to the retirement plan for state agencies, counties, cities, school districts, and other participating political subdivisions and does not include the Mississippi Highway Safety Patrol Retirement System, the Supplemental Legislative Retirement Plan, or the closed Municipal Retirement System that no longer accepts new participants.

[11] At the time of publication of this report, NASRA had not released information for the period ending June 30, 2015.

2015, the PERS Board of Trustees continued to adhere to the asset allocation model put in place in 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.

Exhibit 2, below, shows the actual 2015 investment allocation compared to the model.

Exhibit 2: PERS's Actual Asset Allocation Compared to Allocation Model, as of June 30, 2015

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%
2015	35%	22%	20%	10%	5%	7%	1%

SOURCE: Callan Associates Inc.

Also, 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's professional staff.

Other Issues of Note for PERS

PEER notes two other issues that could be of interest as they relate to PERS:

- a proposed change from an eight-year vesting period to a four-year vesting period; and,
- implementation of Governmental Accounting Standards Board's Statement No. 68 by component Mississippi entities.

Proposed Change 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. As it did in FY 2015, the PERS Board is suggesting that the Legislature return the vesting period to four years.

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 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 potential impact of 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. According to PERS management, the impact to the funding ratio for this change as of June 30, 2015, would be essentially the same as the figures compiled for the period ended June 30, 2013.

Retirement plans have become a major tool for recruiting employees to work in 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. While PEER takes no position on returning the vesting period to four years, as in Fiscal Year 2015, the PERS administration is suggesting that the Legislature return the vesting period to four years.

Implementation of Reporting Requirement Changes for PERS Employers

For Fiscal Year 2015, all employers participating in the PERS plan that issue Generally Accepted Accounting Principles (GAAP) financial statements must comply with the requirements of Governmental Accounting Standards Board Statement No. 68. While the changes outlined in Statement No. 68 will affect the presentation of participating employers' financial statements, the actual financial position of participating employers will not be affected.

In June 2012, the Governmental Accounting Standards Board (GASB) adopted Statement No. 68, *Accounting and Financial Reporting for Pensions.* Statement No. 68 requires governmental entities providing defined benefit pensions to recognize their long-term obligation for pension benefits as liabilities and to measure the annual costs of pension benefits more comprehensively and comparably. This will affect governmental entities nationwide.

As per the requirements of Statement No. 68,[12] for Fiscal Year 2015, employers (e. g., state agencies, counties, school districts, municipalities, and other participating government entities) that issue GAAP financial statements are required to include a proportional share of their retirement plan's (i. e., in Mississippi, PERS's) net pension liability on their financial statements and to recognize their proportionate share of the plan's pension expenses on their financial statements. While these changes will impact the look of an entity's financial statements, they do not impact the actual financial position of the retirement system or the entity's financial commitments.

In complying with GASB No. 68 and to assist participating employers, the PERS plan developed a GASB section on its website that provides total net pension liability and pension expense figures for the plan to each participating employer along with the information necessary for each employer to calculate its proportionate share of liability and expense. The employer's management, in conjunction with its accounting service providers, must calculate the employer's proportionate share of each figure for inclusion in its financial statements.

[12]Statement No. 68 will take effect for governments in fiscal years beginning after June 15, 2014 (that is, for years ended June 30, 2015, or later).

Recent Delays in the Processing of PERS Members' Applications for Service Retirement

Applying to PERS for service retirement benefits is a two-step process that requires completion of both a pre-application for Service Retirement Benefits and a Service Retirement Application. Each step in the process requires the completion of forms, processing of these documents by PERS staff, and a quality assurance review of the processed application by additional PERS staff. Although PERS recommends that members file for benefits ninety days in advance of their anticipated retirement date, the PERS staff notes that in many cases, and under normal operating conditions, the processing of applications for service retirement benefits may be completed in as short a time as thirty days.

However, from March 2015 through September 2015, the Public Employees' Retirement System experienced delays in the processing of applications for service retirement benefits. According to PERS estimates, approximately 2,000 applications from that period were affected, experiencing processing times that did not allow for the completion of the applications within the ninety-day period recommended by PERS.

According to PERS staff, as of September 15, 2015, all of the delayed applications for service retirement benefits had been processed. All applicants who completed the retirement process by submitting the required documents have been added to the retirement payroll (with payments retroactive to the initially stated date of retirement).

The recent delays in PERS's processing of applications for service retirement benefits may be attributed to a combination of three factors: the transition to a new pension administration system, employee turnover in key positions, and the timing of the implementation in conjunction with the annual peak volume of applications for retirement service benefits.

Transition to a New Pension Administration System

In July 2015, PERS transitioned from its old pension administration system, Genesis, to its new system—the Mississippi Automated Retirement System (MARS). PERS received notification in early 2004 that the company responsible for providing technical support of the Genesis system would discontinue support in 2009. PERS began exploring options to replace or upgrade the Genesis system and issued an RFP in May 2007.

Due to the bankruptcy of PERS's original choice of service provider, in addition to other delays, the development and implementation of MARS was not initiated until after Genesis no longer was receiving technical support (in 2009). PERS did not begin using MARS to process applications for service retirement benefits until July 2015.

Until recently, PERS operated Genesis[13] as its pension administration system.[14] Genesis had been implemented in 1999, but by early 2004 PERS was notified that the company responsible for providing technical support of the system would begin phasing out support, with a projected end date in 2009.

As noted by ITS, each decision to replace technology assets and systems must be decided by the merits of the situation. Several factors must be considered, including the size/complexity/importance of the asset, the cost of replacing the asset, remaining utility of the existing asset, and safety/security of the existing asset.

The following sections outline the process PERS used in transitioning from the Genesis system to the MARS system. See Exhibit 3, pages 18-19, for a timeline of the delays in the processing of PERS members' applications for service retirement.

Development and Issuance of the Original RFP

PERS issued an RFP for a pension administration system in September 2008 and selected a contractor in February 2009, later rescinding the contract due to the contractor's filing for bankruptcy.

PERS issued an RFP for pension system consulting services in May 2007, signing a contract with L.R. Wechsler, LTD, in November 2007. Wechsler was hired to help define the requirements for a replacement to the existing pension administration system and to monitor the development process of a new pension administration system in conjunction with PERS staff.

After Wechsler and PERS staff completed the assessment of PERS needs for the new system, PERS requested the assistance of ITS in issuing an RFP to procure development and implementation services for a new pension administration system in July 2008. The development and implementation of the new system was estimated to cost $18 million and take three to five years.

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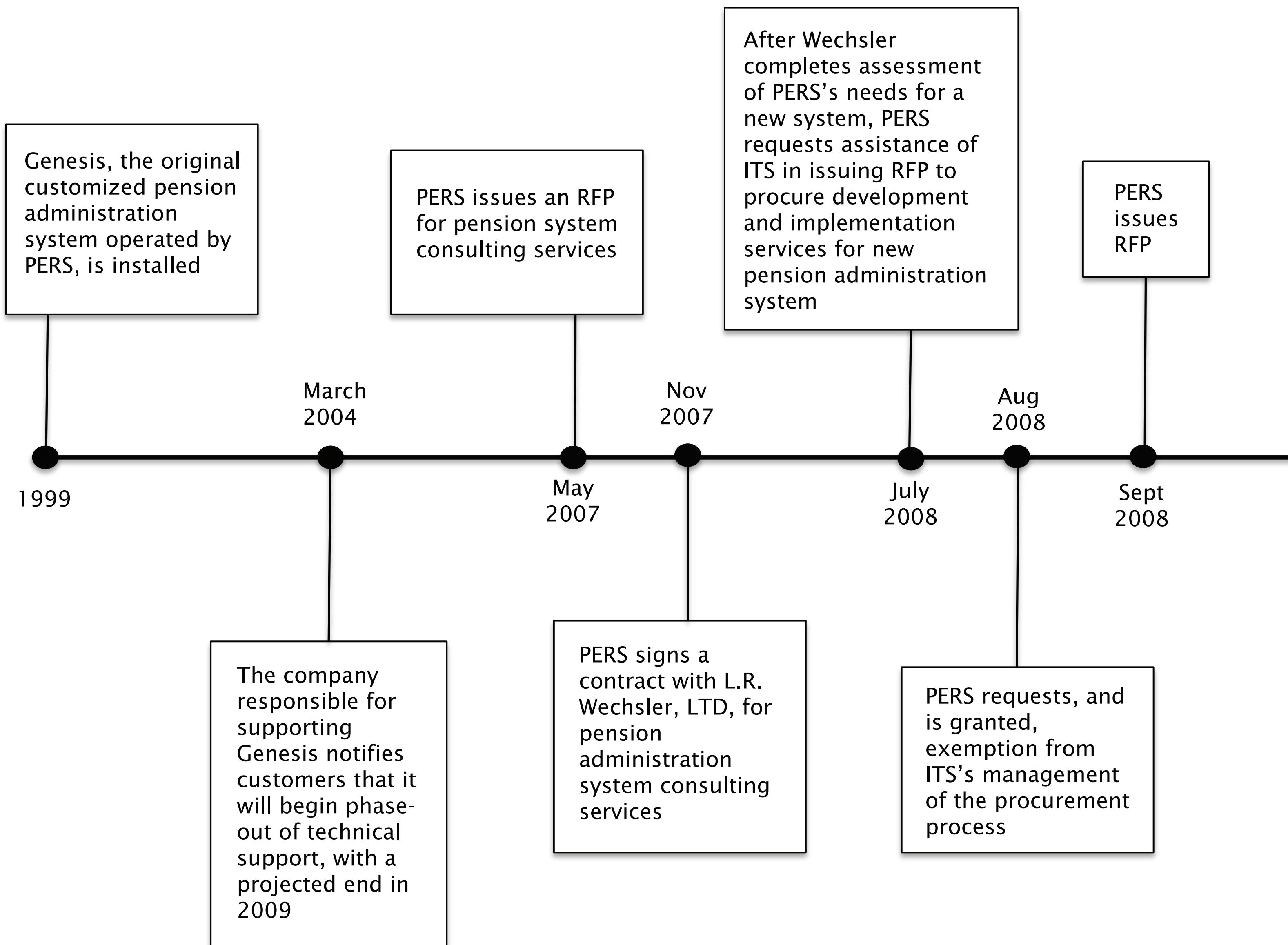
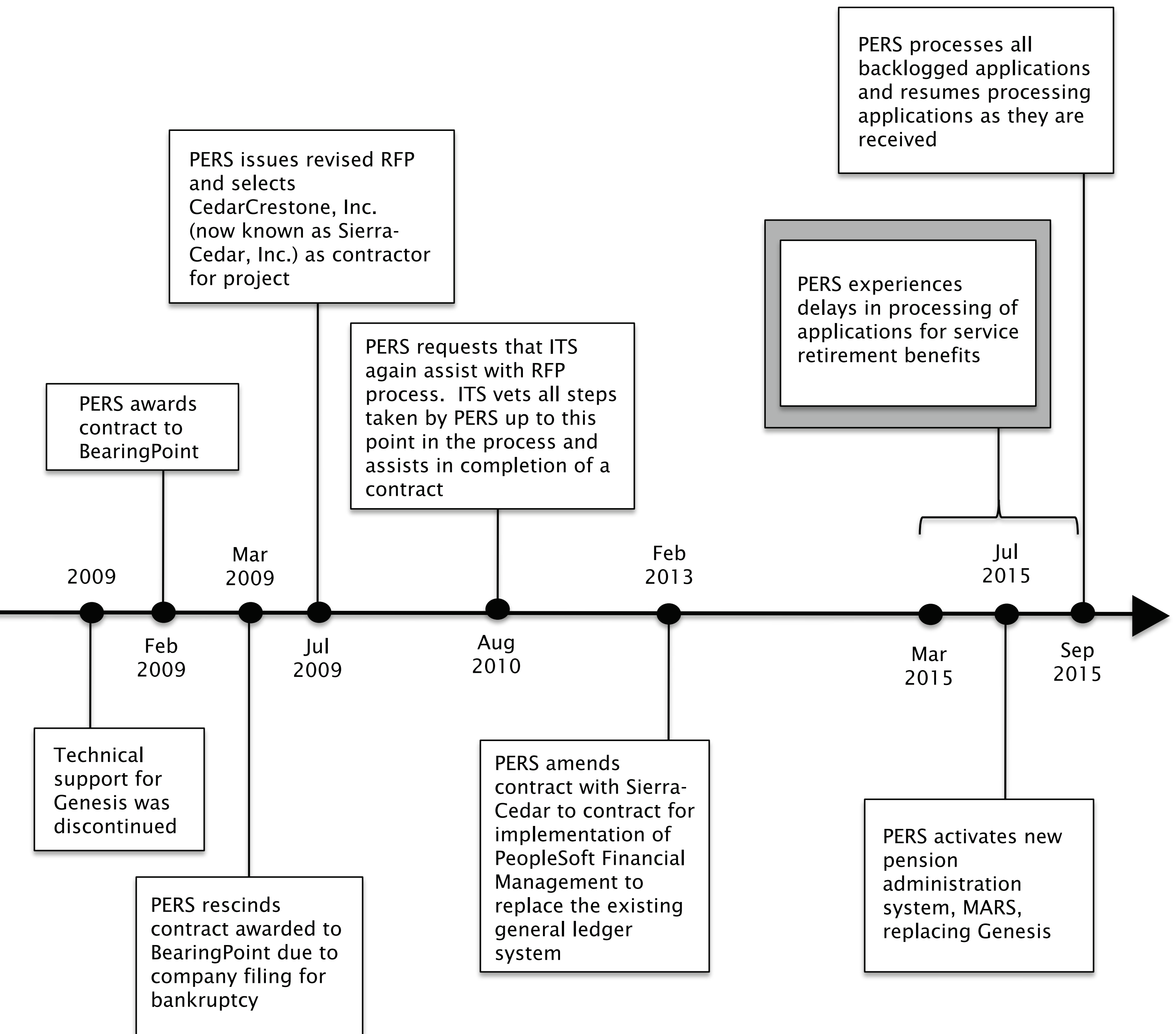
[13]Genesis was the customized pension administration computer system operated by PERS prior to the installation of its new system in July 2015.

[14]PERS's *pension administration system* is the computer system PERS personnel use to manage members' accounts (including processing applications for service retirement benefits).

Exhibit 3: Timeline of Delays in the Processing of PERS Members' Applications for Service Retirement





SOURCE: PERS

According to ITS officials, during development of the RFP, ITS granted, at the request of PERS, an exemption from further ITS involvement in the management of the procurement process. As noted in the *ITS Procurement Handbook*, October 2015, ITS's procedures allow agencies and institutions to request exemption from ITS involvement in the procurement of "traditional information technology equipment, software, or services which the agency/institution has the in-house resources and expertise to procure without ITS involvement."[15]

In light of the exemption request, ITS did not participate in the review and evaluation of proposals. However, at the request of PERS, ITS retained the sealed cost proposals and validated the proposals once they were opened.

PERS issued its RFP in September 2008, selecting BearingPoint in February 2009 at a total project cost of $20.7 million. Later, PERS rescinded the contract awarded to BearingPoint due to the company's filing for Chapter 11 bankruptcy and selling its public services unit[16] to Deloitte in March 2009.

Issuance of a Second RFP

PERS issued a revised RFP for a pension administration system in July 2009 and finalized a contract with CedarCrestone, Inc. (now known as Sierra-Cedar, Inc.) in August 2010.

PERS issued a revised RFP in July 2009, again seeking bids for the development and implementation of a new pension administration system. The contract was awarded to CedarCrestone, Inc. (now known as Sierra-Cedar, Inc.), with the total project cost increasing to $24.4 million after receipt of best and final offers and inclusion of additional hardware needed for the new system.

During the negotiations of the contract, issues over limitations of liability for the use of the new pension administration arose between PERS and Sierra-Cedar. ITS once again became involved in the selection process as issues of limiting contractor liability arose.[17] Because the Executive Director of ITS is the only person able to negotiate on such issues for the acquisition of computer equipment and services, PERS requested that ITS again assist with the RFP process. ITS vetted all of the steps taken by PERS to that point in the process and assisted in the completion of a contract in August 2010.

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[15]PERS is also exempt under state law. See MISS. CODE ANN. Section 25-11-15 (8) (1972) and the Mississippi Attorney General's *Opinion to F.M. Walker* on June 5, 1986.

[16]BearingPoint's public services unit is the division of its operations responsible for technology and management consulting services for its federal and state government clients.

[17]Per MISS. CODE ANN. §25-53-21 (e) (1972), in information technology contracting, the ITS Executive Director has the authority to approve limitations on contractor liability to the state for damages the state might suffer arising out of computer systems' failures.

While ITS was not formally involved in every step of the contracting process, both PERS and ITS stated that an informal dialogue was maintained between the agencies throughout the process.

Rollout of MARS

Rollout of MARS began with installation of new imaging software in 2012, but PERS did not begin using MARS to process applications for service retirement benefits until July 2015.

The development and implementation of the new pension administration system, the Mississippi Automated Retirement System (MARS), was designed as a two-pronged rollout accomplished through twelve phases. The original contract called for all phases to be completed by the fourth quarter of 2013, with the new imaging software placed in service by the third quarter of 2011. In an effort to reduce the development and implementation time of MARS, PERS decided to implement the new system all at one time, when all the phases were complete, instead of implementing each phase as it was ready.

During the development of the RFP for the development and implementation of MARS, PERS consulted with Sierra-Cedar about replacing its existing general ledger software, CODA (named after the company that developed the software), but elected not to install it in conjunction with MARS due to time constraints. However, during the development of MARS, it was determined that the level of customization required to allow the MARS system to interface with CODA would put the timely completion of the project in jeopardy.

Additionally, because PERS would have to issue an RFP to procure services to allow CODA to interface with the new Mississippi's Accountability System for Government Information and Collaboration (MAGIC), and then pay for similar services in the development and implementation of its new general ledger software, PERS decided to move up its replacement of the general ledger software. PERS amended the contract with Sierra-Cedar in February 2013 to contract for the implementation of PeopleSoft Financials. This amendment provided for a separate team to conduct the work of replacing CODA. While all phases of development and implementation essential to the operation of MARS as the pension administration system of PERS were placed into service in July 2015, other functions, such as self-service interfaces for members and retirees, are still under development.

Processing Delays Began in Early 2015

PERS began experiencing delays in processing times for new retirement applications in early 2015 and in July 2015 began updating its website with weekly updates that explained the progress of PERS staff in clearing the backlog of applications.

As the development of MARS entered early 2015, PERS staff was still processing retirement applications in Genesis and began to experience delays in processing times for new retirement applications due to decreases in the efficiency of processing operations in Genesis and computer system capacity. In an effort to notify members who were beginning the application process of potential delays, PERS began including modified language in Form 9A SRVC (*Pre-Application for Service Retirement Benefits)* receipt letters. The letter stated, "We apologize for the delay in servicing your request for retirement, but PERS is currently in the process of replacing our computer systems, which is resulting in significant delays."

As the delays continued to worsen, PERS issued two separate Employer eUpdates (on May 21st and July 17th) and asked employers to share this information with all employees that might be affected. In the July employer eUpdate, PERS explained that it would be updating its website with weekly updates that explained the progress of PERS staff in clearing the backlog of applications for service retirement benefits. For example, on July 17, 2015, PERS updated its website home page to notify applicants that PERS analysts were currently processing retirement applications submitted the week of March 23, 2015.

PERS continued updating its website on a weekly basis through the week of September 11, 2015, ultimately reaching a point on that date at which PERS had processed all the backlogged applications and had resumed processing applications as they were received.

While PERS and Sierra-Cedar are still addressing implementation issues associated with the transition from Genesis to MARS, the new PERS pension administration system has additional capabilities that should help to increase the future efficiency of operations. The overall speed of the system has increased and the system notifies PERS staff when an action is needed. Additionally, the new system will allow PERS to maintain a database of current contact information, such as personal e-mail addresses of members and retirees that will facilitate communication of information in the future. Once implemented, members and retirees will be able to update their own information through new self-service interfaces.

Employee Turnover in Key Positions

The loss of institutional knowledge and experienced workers in both the service retirement and management information systems (MIS) departments could have contributed to the recent delays in the processing of members' applications for service retirement benefits.

Since 2010, PERS has experienced high turnover in both its service retirement and management information systems (MIS) departments. The operations of each of these departments have played an important role in phases of PERS operations that affect the processing of applications for service retirement benefits. PERS employees in the service retirement department are responsible for the receipt, processing, and auditing of retirement applications. PERS employees in the MIS department were responsible for the continued maintenance of the Genesis system, as well as assisting in the testing and implementation of the new MARS system.

Since 2012, PERS has had to fill twelve of the twenty positions within its service retirement department and sixteen of the twenty-six positions within its MIS department, which represent 60% and 62% of these departments' staffs, respectively. Of the collective turnover, seventeen positions had five years' or more experience and ten of the positions included some form of supervisory responsibility. The loss of institutional knowledge and experienced workforce could have contributed to the delays in the processing of members' applications for service retirement benefits.

Annual Peak Volume of Applications

PERS's processing delays were exacerbated by their occurrence during a period during which the system traditionally receives its highest volume of service retirement applications each year.

An additional factor that should be considered as potentially contributing to the delays in PERS's processing of the applications for service retirement benefits is the timing of the applications. PEER believes that applicants for service retirement benefits experienced delays in the processing of their applications due to delays in the development and implementation of MARS and high turnover in key positions in conjunction with PERS's peak retirement application processing period.

As noted previously, PERS staff recommends, when possible, that members applying for service retirement benefits start the process at least ninety days ahead of their projected retirement date. That is the period outlined in the PERS Member Handbook, PERS Retirement Guides, and educational sessions. Of the 2,000 applications that experienced delays, PERS estimates that one-third of these applications followed PERS recommendations.

However, the issues discussed earlier in this chapter led to slower processing of applications by the PERS staff through most of second quarter of 2015, a period during which PERS traditionally receives its highest volume of service retirement applications each year. PERS receives a high volume of applications during this period primarily because retirement by July 1, the beginning of a fiscal year, allows the retiree to begin receiving his or her cost of living adjustment (COLA) increase at the earliest possible future date. Additionally, this period may have a higher volume of applications due to coinciding with the end of the contract year for public school teachers.

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

Since the PEER report *The Public Employees' Retirement System of Mississippi: A Review of Selected Issues Related to Financial Soundness* (Report #564, December 11, 2012), the Committee has annually provided an update on significant retirement litigation arising out of state legislative initiatives that have sought to change retirement plan benefits, including cost of living adjustments. These updates reinforce the idea that there are risks associated with modifying benefits offered to active employee members of retirement systems and retirees. The cases noted in this report bear out this trend.

Briefly, the 2012 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 2014 PEER report 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, and detailed in this report, the contractual rights of employees and retirees have generally 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 focuses on three cases that were rendered after the issuance of the Committee's 2014 update on the retirement system (*An Update on the Financial Soundness of the Mississippi Public Employees' Retirement System and Related Legal Issues: 2014*; January 5, 2015; Report #591). Cases from Illinois, New Jersey, and Rhode Island all address state legislative attempts at reforming pension benefits, including such things as age and service duration requirements for retirement. An additional case from California is also mentioned more for its implications than for its narrow holding. PEER further updates cases from Texas and Ohio that were in discovery as of 2014.

Illinois

One of the most significant cases to be reported since PEER's 2014 update has come from Illinois. Major revisions in the benefits structure for several of Illinois's retirement programs were enacted in 2013, but resulting litigation resulted in these changes being nullified. In *In Re Pension Reform Litigation,* 392 Ill Dec 1, 32 N.E 3d. 1 (Ill, 2015), the Illinois Supreme Court struck down 2013 changes to the retirement system that had:

- changed the minimum age at which persons may retire and draw their annuity;
- eliminated the three percent annual increases authorized by law;
- capped the maximum salary for which annuities may be earned; and,
- changed the benefits calculation for certain system participants.

The Illinois Supreme Court concluded that the changes violated a specific provision of that state's constitution--Article XIII, Section 5, that establishes a retirement system member's contractual right to pension benefits. While the Illinois provision is unique, the court's analysis is identical to that employed by other courts when they address alleged violation of the more general obligation of contracts clause. The court concluded:

- Once persons become employees and members of a retirement system, they acquire contract rights in the pension benefits that are offered to them at the time they join the system.
- The state could not establish that changes to the benefits structure were reasonable and necessary even in the face of poor market performance in the late period of the last decade. Consistent with this, the court cited older cases wherein economic conditions were not held to provide sufficient cause for defeasing contractual rights.
- Further, the state legislature had knowledge of the problems in the retirement system for many years, but had chosen to delay addressing these problems in order to meet other budgetary demands.
- The effect of this decision is that the state will now have to shoulder a multi-billion-dollar bill to address the funding deficiencies in the Illinois retirement systems.

New Jersey

The New Jersey Supreme Court was faced with an issue different from that placed before the Illinois court. In *Burgos v. Christie*, (NJSC, A-55-14, decided June 9, 2015), the New Jersey Supreme Court was faced with a suit for injunctive relief against the Governor and others mandating that the terms of a 2011 enactment be honored that required that funds be appropriated to reduce the unfunded liability of pension systems the state administers. The general law upon which petitioners relied also made clear that a contractual right exists between the public employees of New Jersey and the governmental employers who pay into the retirement systems for their benefit.

On appeal, the New Jersey Supreme Court held that that there was no legal requirement to fund according to the 2011 legislation. The court's reasoning included the following:

- The contractual obligation set out in the Chapter 78 2011 legislation is not binding on the state, as it violates the Debt Limitations Clause of the New Jersey Constitution, violated the New Jersey Constitution Article VIII, Section 2, Cl 3, and the Appropriations Clause, Article VIII, Section 2, Cl 2.
- These provisions require that budgets be balanced and that financial obligations to spend be limited to one fiscal year at a time.
- The effect of Chapter 78, if applied, would be to obligate the legislature to spend more in one fiscal year than resources might permit; consequently, compliance with the provision cannot be ordered by the court.
- The court did state that the decision should not be read as to conclude that there is no contractual right to receive pension benefits. The decision simply makes clear that the legislature cannot be bound by general law to make certain funding decisions in outlying years by general law. Such decisions apparently have to be made on a year-by-year basis.

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.

In June 2015, in an effort to avert continued litigation, most unions and others who were parties to the litigation entered into a settlement with the state of Rhode Island regarding the pension system changes that were the subject of litigation.

Parties to the litigation accepted the settlement, which resulted in:

- a COLA payable on the first $30,000 of pension benefits payable every four years until such time as the retirement funding reaches 80%;

- a $500 stipend paid to each retiree per year for the next two years;
- employees with twenty years of creditable service are returned to the defined benefits plan, although they must pay additional benefits to be in that system; and,
- a rule of ninety-five (age plus years of service) as the minimum for retirement without regard to the retiree's age.

In discussing the legal issues associated with the settlement, the Superior Court Judge noted that there is considerable case law to support the proposition that COLAs are not a form of protected property because they are recalculated every year. Consequently, there could be no reasonable basis for an employee to expect a particular COLA each year.

In distinguishing the Rhode Island case from those in other jurisdictions, particularly those in Oregon and Illinois, the court noted that in Rhode Island, repeated attempts to make reforms to the pension system had failed, making changes both reasonable and necessary. In the face of this need, the state could abrogate the contractual rights of the state's employees. It noted that this makes the situation in Rhode Island distinguishable from that in Illinois and Oregon. PEER would note that the settlement agreement does not detail the financial conditions that the court concluded had made the changes and agreed settlement reasonable and necessary.

It should be noted that three unions are continuing their litigation in this matter and that could impact the viability of the settlement.

California

In 2014, PEER reported about the case *San Jose Police Officers' Association v. City of San Jose* (Superior Court for the County of Santa Clara, April 29, 2014). In this case, 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. While the city was appealing the lower court decision, press reports from August 2015 show that the local government has chosen to terminate its appeal of the ruling in the face of heated negotiations over union contracts.

While not reaching a conclusion on a constitutional issue, the California Court of Appeals for the Fourth District concluded that law enforcement officers covered under a multi-year collective bargaining agreement had a contractual right to have contribution rates applied as agreed to in the collective bargaining agreement, even though plan changes were made

legally effective prior to the end of the bargaining agreement that would have changed the required levels of contribution. The court cited the usual provisions of California law setting out the California Rule, but followed the well-established principle of not resolving a dispute on constitutional grounds when lesser grounds could be used to resolve the dispute. See *Deputy Sheriff's Association of San Diego v. County of San Diego*, 233 Cal App 4th 573, __ Cal Rptr 3d___ (Cal App, 2015). In view of the court's recitation of past holdings on impairment of contracts, it seems doubtful that the court would have ruled against the system members if there had been no bargaining agreement covering their contribution rates.

Texas

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. The court dismissed this case in April 2015.

Ohio

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. A proposed settlement hearing is scheduled for September 2015.

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.

Cases cited below find a contractual right to COLAs for employees who were receiving COLAS at the time restrictive rules limiting the payment of adjustments became effective.

California

In 2015, California joined the majority of jurisdictions that have dealt with the question of whether a COLA is to be considered a part of the contract between a retirement system member and the state. In *Protect Our Benefits v. City and County of San Francisco,* 235 Cal App 4th 619, ___ Cal Rptr 3d ___ (Cal App, 2015) the California Court of Appeals for the First District ruled that a retiree's expectation of a COLA is a part of his or her contract with the state that cannot be impaired. In 2011, the voters of the county adopted an initiative that barred the payment of COLAs until such time as the retirement system is fully funded based on a valuation of the previous year's assets. During the last decade, the city had made the COLA permanent and had actually raised it in 2008. After citing the California Rule requiring that any impairments must be accompanied with new benefits to be constitutional, the court noted that several older cases from the jurisdiction had held that retirees had a vested constitutional right to their COLA. The court further concluded that at no time since the COLA was made permanent was full funding ever a part of the pre-conditions to receiving a COLA. Without benefits inuring to the retirees, the class of retirees who had first started receiving a COLA when the mandatory COLA was adopted could continue to receive their annual adjustments.

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.

Last year, PEER reported that oral arguments had been made in the case cited above. In 2015, the Oregon Supreme Court rendered its decision in *Moro v. Oregon*, 357 Or 157, ___ P. 3d __, (2015). In *Moro*, the Oregon Supreme Court was faced with a question of whether COLAs and tax offsets offered to Oregon

retirees were protected under the Oregon Constitution's Obligation of Contracts clause. The court concluded that COLAs were in fact protected. In so ruling, the court reasoned in brief as follows:

- While no formal written contract exists between employees and the state, under contract law, a unilateral contract exists between the parties. This is because the state offers compensation, including retirement, to persons who accept by performing their duties and responsibilities.
- The COLA is not intended to be a bonus or a performance based payment, but is part of the basic pension benefit. It is paid out of the employee/employer contributions and the revenues these generate to provide some safeguard against inflation.
- The COLA was set in law based on a statutory formula derived from the consumer price index for the Portland area times a multiplier.
- Because the employees were in fact in a contractual relationship with the state, and their benefits were part of the retirement pension, and further, they had an expectation to receive COLAs based on a set formula, the court accepted the employee/retiree argument that changes intended to reduce the COLAs violated the Obligation of Contracts Clause.

In a matter unrelated to COLAs, the court ruled that tax offsets, extra amounts paid to taxpayers as part of a settlement when retirees sued to protect their income tax exempt status for pension income, were not part of the employment contract. The court reasoned that these were simply part of a settlement of potential liability, but not part of a contract. The court left open the possibility that suits could be maintained for violation of the settlement.

Analysis of Recent Legal Actions

While some cases that PEER has reported in the past few years have allowed modification of benefits for system members and employees, the trend seems to favor protecting the benefits of employees. At this point, even COLAs are more likely to be protected when retirees can show that law or regulations created a reasonable expectation that a certain COLA would be payable.

Last year, PEER mentioned that cases from California, Oregon, and Rhode Island did bear scrutiny, as these might make clear the future trajectory of the future of retirement litigation. In addition, the recent case from Illinois is of considerable significance.

Thus far, cases from the highest courts in Oregon and Illinois have been defensive of employee benefits and have struck down legislative attempts to reduce or modify these benefits. The commonly used argument for protecting these benefits has

been the state's constitutional prohibition against impairing the obligation of contracts. Illinois litigation hinged on a special provision of the state's contribution that makes pension benefits a constitutional right, but the court's analysis quite self-consciously follows the usual line of analysis found in impairment cases. While some commentators consider the Illinois case to be unique because its narrow holding is based on a unique constitutional provision, a closer look below this mere surface reading tends to reinforce the idea that the court was thinking in terms of impairment of obligations. Thus, the court's reasoning would be applicable to cases litigated in jurisdictions that lack a clause specifically protecting pension benefits as contractual rights.

The Rhode Island case is unique in that it applies to a settlement of claims between several unions brought against state and local retirement systems in the state. It would appear to PEER that the financial conditions in Rhode Island might have made employee unions willing to bargain away what might have been otherwise defensible contractual rights. As for whether this case would be instructive for policymakers in Mississippi, PEER would note:

- we do not have strong employee unions in this state that can bargain for employees; and,
- as noted in PEER's 2012 report, it is very difficult to argue that modifications to Mississippi's retirement system would be reasonable and necessary in view of the state's ability to pay projected future claims.

These factors distinguish Mississippi from Rhode Island. PEER would also note that the Rhode Island court's reading of the Illinois and Oregon cases appears superficial, particularly its analysis of the Illinois case as being entirely based on a unique clause of the state's constitution.

The 2014 report also mentioned cases from California. Only one new case of significance, *Protect Our Benefits v. City and County of San Francisco,* supra, found a contractual right to a COLA for persons who had been receiving COLAs based on laws and regulations that made a COLA a clearly expected benefit. This case is in no way unusual and reflects what an informed reader would expect from a jurisdiction applying the California Rule to protect the benefits of retirement system members. Several cases dealing with the California Rule should be working their way through the courts and may be resolved in the foreseeable future, although as the government decision to drop the case dealing with San Jose reveals, the strength of the California Rule, coupled with labor unions' strong influence in California, may result in many appeals not being pursued in instances wherein they impact current employees or retirees.

PEER would note that COLA benefits are the one benefit most likely to fall outside of the "contract." Cases compiled over the past three years show marked differences between the way different jurisdictions address rights to a COLA. The cases

PEER reports this year from California and Oregon, both "California Rule" jurisdictions, protect rights of recipients. PEER notes that in earlier reports, the Committee reported several cases from jurisdictions such as Colorado, Minnesota, Maine, and Washington that did not find a contractual right to a COLA. This contrasts with cases reported from Arizona, California, New Jersey, and Oregon that have found such a right. As we noted last year, since Mississippi has applied the California Rule in the past, cases from jurisdictions such as California and Oregon may be most instructive for Mississippi's policymakers to follow.

PEER notes that although cases from foreign jurisdictions might not be of particular significance when assessing the constitutionality of possible changes to Mississippi's PERS, the Committee would suggest that cases from so-called "California Rule" jurisdictions are of particular interest to policymakers, as our state does apply this rule when reviewing claims of constitutionality of pension plan changes.

Agency Response

PERS *of* MISSISSIPPI

Providing Benefits for Life

December 8, 2015

Mr. James Barber
Executive Director
Joint Committee on Performance Evaluation and Expenditure Review
Woolfolk Building, Suite 301-A
501 North West St.
Jackson, MS 39201

Dear Mr. Barber:

Thank you for the opportunity to review the draft of the PEER Report titled *The Public Employees' Retirement System: 2015 Update on Financial Soundness, Delays in Application Processing, and Legal Issues.* As acknowledged in the Report, the PERS Board of Trustees, in conjunction with the biennial experience review, made adjustments to the actuarial assumptions in an effort to present a more conservative forecast of the System's future performance. PERS strives to be above reproach in handling the funds entrusted to us because we understand how significantly our work affects families across the state of Mississippi. This mission keeps us dedicated to the long-term sustainability of the System by focusing on competent, prudent management practices and strict adherence to the PERS funding policy.

This year has been extraordinary and extremely challenging for PERS. The backlog and conversion to the Mississippi Automated Retirement System (MARS)—in addition to staffing issues—inhibited our ability to deliver the quality services our members expect and deserve. As noted in the Report, PERS has resumed its normal processing pace and is, once again, providing efficient retirement services to our members. However, we continue to evaluate our processes and challenges to ensure we meet and surpass customer expectations.

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

Pat Robertson
Executive Director

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