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July 25, 2008

Representative Bette Grande, Chair
Employee Benefits Program Committee
State of North Dakota
Bismarck, North Dakota

Re: **Technical Comments – Bill Draft No. 90111.0100**

Dear Sparb:

The following presents our analysis of the proposed changes found in Bill Draft No. 90111.0100:

Systems Affected: North Dakota Public Employees Retirement System (Hybrid Plan) and Highway Patrol Retirement System

Summary: The proposed legislation would make the following important changes:


The PERS Board is presently authorized to appoint 3 of its 4 elected members to the State Investment Board (SIB). This change would allow the Board to appoint as one of its 3 members a non-elected PERS Board member such as the Board Chair who is appointed by the Governor, the Attorney General's appointment, or the Health Officer or designee.

Authorizes payment of employee contributions on a pre-tax basis, instead of on an after-tax basis, in the Highway Patrol Retirement System and the Judges retirement plan via employer pick-up under Internal Revenue Code rules, for compensation earned after August 1, 2009.

Allows members of the Hybrid Plan and Highway Patrol Retirement System to select a non-spouse beneficiary as a joint annuitant for the joint and survivor benefit options (50% or 100% survivor benefit). Any non-spouse beneficiary selected for the joint and survivor benefit options must not be more than ten years younger or older than the member. If the member is married, his or her spouse must consent to any non-spouse beneficiary designation.

Allows members of the Hybrid Plan and Highway Patrol Retirement System to designate a subsequent beneficiary, either after the death of the original beneficiary or upon divorce of the member, for retirees who elected a joint and survivor benefit option.

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Allows members of the Hybrid Plan and Highway Patrol Retirement System to elect a new optional form of monthly retirement benefit that provides a graduated increase of 1% or 2%. The monthly retirement benefit would be actuarially adjusted to provide for the post-retirement increases.

Eliminates the 60-month certain option as a form of payment for surviving spouses in the Hybrid Plan.

Allows members of the Hybrid Plan and Highway Patrol Retirement System to purchase up to ten years of service credit, instead of five years, unrelated to other eligible service. A maximum of five years of service credit purchased under this provision would count towards retirement eligibility for Rule of 80 (Highway Patrol) or Rule of 85 (Hybrid Plan).

Updates federal compliance provisions of the Hybrid Plan and Highway Patrol Retirement System, including additional language to comply with Internal Revenue Code section 415(b) and related regulations.

Present law provides that any member of the PERS retirement plan can run for election to the PERS Board. The Board is proposing to broaden the election to include members of the Highway Patrol Retirement System, Job Service Plan and Defined Contribution Plan. These plans are also administered by the Board.

Actuarial Cost Analysis: This bill would have an actuarial impact on the Hybrid Plan and the Highway Patrol Retirement System. Since the Normal Form for the Highway Patrol and the Judges is a 50% Joint and Survivor annuity, this bill will allow non-married members to receive an unreduced Joint and Survivor benefit. Alternately, members of these plans electing a non-spouse beneficiary could have their benefit reduced as it is in the Main plan, however, the bill does not currently provide for this.

Technical Comments: Our comments on the bill are as follows:

Benefits Policy Issues

➤ Adequacy of Retirement Benefits

While the graduated increase option provisions of this bill would not enhance the adequacy of the retirement benefits, such provisions allow a member to better distribute their benefit payments during retirement with the graduated 1% or 2% option. This option would not apply to the level social security benefit. An example of the payments under this option for a member with a normal retirement monthly benefit of \$1,000 retiring at age 65 is as follows:

Retiree Age	Monthly Single Life Benefit	Monthly Graduated Benefit with 1% Annual Increases	Monthly Graduated Benefit with 2% Annual Increases
65	\$1,000.00	\$925.67	\$853.93
66	\$1,000.00	\$934.93	\$871.00
67	\$1,000.00	\$944.28	\$888.42
68	\$1,000.00	\$953.72	\$906.19
69	\$1,000.00	\$963.26	\$924.32
70	\$1,000.00	\$972.89	\$942.80
71	\$1,000.00	\$982.62	\$961.66
72	\$1,000.00	\$992.45	\$980.89
73	\$1,000.00	\$1,002.37	\$1,000.51
74	\$1,000.00	\$1,012.39	\$1,020.52
75	\$1,000.00	\$1,022.52	\$1,040.93
76	\$1,000.00	\$1,032.74	\$1,061.75
77	\$1,000.00	\$1,043.07	\$1,082.98
78	\$1,000.00	\$1,053.50	\$1,104.64
79	\$1,000.00	\$1,064.04	\$1,126.74
80	\$1,000.00	\$1,074.68	\$1,149.27
81	\$1,000.00	\$1,085.42	\$1,172.26
82	\$1,000.00	\$1,096.28	\$1,195.70
83	\$1,000.00	\$1,107.24	\$1,219.62
84	\$1,000.00	\$1,118.31	\$1,244.01
85	\$1,000.00	\$1,129.50	\$1,268.89

This bill would also allow a member to increase the adequacy of their retirement benefit by purchasing an additional 5 years of service credit. This purchase would be limited in scope however, since it would only increase a member's years of service under the benefit formula but would not count towards Rule of 85 retirement eligibility. The following illustrates the service purchase methodology:

Example	Cost
Age: 29 years Service on File - 5 years Current FAS - \$29,000 Purchase - 1 year	\$4,116.79 (\$4,030.52 for retirement portion; \$86.27 for retiree health credit portion)
Age: 44 years 11 months Service on File - 21.95 years Current FAS - \$53,927 Purchase - 1 year	\$10,717.95 (\$10,395.34 for retirement portion; \$322.61 for retiree health credit portion)
Age: 54 years Service on File - 32 years Current FAS - \$44,626 Purchase - 1 year	\$10,487.31 (\$9,896.55 for retirement portion; \$590.76 for retiree health credit portion)

➤ Benefits Equity and Group Integrity

The PERS Board is proposing to expand the eligibility for Board membership to members of retirement systems administered by the Board other than PERS. This includes the Job Service Plan, the Highway Patrol Retirement System and the Defined Contribution Plan. This change is reflective of the scope of the Board's responsibility and enhances the equity and integrity of PERS by allowing all members the opportunity to serve on the Board.

Authorizing employee contributions on a pre-tax basis for members of the Highway Patrol Retirement System and Judges retirement plan provides for employee contributions in a manner similar to those of their peers in other State retirement systems under the Board's authority. This will also enhance the take home pay for members of these systems. The following examples are based on information provided by PERS' staff and illustrate the effect of the tax treatment:

Highway Patrol									
Contributions Post-tax (Current)									
Monthly Salary	Taxable Salary	Federal Tax (8.48%)	State Tax (1.39%)	Social Security (0.00%)	Medicare Tax (1.45%)	Retirement Contribution (6.30%*)	Total Paycheck	Paycheck Increase	Paycheck Increase Percent
2,000.00	2,000.00	169.60	27.80	0.00	29.00	126.00	1,647.60		
3,000.00	3,000.00	254.40	41.70	0.00	43.50	189.00	2,471.40		
4,000.00	4,000.00	339.20	55.60	0.00	58.00	252.00	3,295.20		
5,000.00	5,000.00	424.00	69.50	0.00	72.50	315.00	4,119.00		
Contributions Pre-tax (Proposed)									
2,000.00	1,874.00	158.92	26.05	0.00	29.00	126.00	1,660.03	12.43	0.75%
3,000.00	2,811.00	238.37	39.07	0.00	43.50	189.00	2,490.06	18.66	0.76%
4,000.00	3,748.00	317.83	52.10	0.00	58.00	252.00	3,320.07	24.87	0.75%
5,000.00	4,685.00	397.29	65.12	0.00	72.50	315.00	4,150.09	31.09	0.75%

* The employee contribution rate is 10.30% of pay, but 4.00% is picked up by the employer.

Judges									
Contributions Post-tax (Current)									
Monthly Salary	Taxable Salary	Federal Tax (8.48%)	State Tax (1.39%)	Social Security (6.20%)	Medicare Tax (1.45%)	Retirement Contribution (1.00%)	Total Paycheck	Paycheck Increase	Paycheck Increase Percent
6,000.00	6,000.00	508.80	83.40	372.00	87.00	60.00	4,888.80		
7,000.00	7,000.00	593.60	97.30	434.00	101.50	70.00	5,703.60		
8,000.00	8,000.00	678.40	111.20	496.00	116.00	80.00	6,518.40		
9,000.00	9,000.00	763.20	125.10	558.00	130.50	90.00	7,333.20		
Contributions Pre-tax (Proposed)									
6,000.00	5,940.00	503.71	82.57	368.28	87.00	60.00	4,898.44	9.64	0.20%
7,000.00	6,930.00	587.66	96.33	429.66	101.50	70.00	5,714.85	11.25	0.20%
8,000.00	7,920.00	671.62	110.09	491.04	116.00	80.00	6,531.25	12.85	0.20%
9,000.00	8,910.00	755.57	123.85	552.42	130.50	90.00	7,347.66	14.46	0.20%

➤ Competitiveness

No impact.

➤ Purchasing Power Retention

Since the optional form of a graduated increase of 1% or 2% in monthly benefits is paid for by the member's own retirement accruals, it is not anticipated to maintain the purchasing power of retirement benefits. However, it will allow participants to budget for increases in inflation by shifting payments from the present to the future.

➤ Preservation of Benefits

This bill enhances the preservation of retirement benefits in two ways:

1. The ability of members to designate a subsequent beneficiary due to the death of the original beneficiary preserves the benefits of affected members whose monthly retirement benefits are actuarially reduced to provide a survivor benefit to an individual who has died.
2. The ability of member to select a non-spouse beneficiary enhances the preservation of benefits, since a member can pass along their accrued retirement benefit to another individual such as a sibling or other family member.

➤ Portability

No impact.

➤ Ancillary Benefits

No impact.

Funding Policy Issues**➤ Actuarial Impacts**

1. Non-spouse beneficiaries: Currently, the normal form for the Highway Patrol and the Judges is a 50% joint and survivor annuity. Thus, married members receive a 50% joint and survivor benefit, and unmarried members receive a straight life annuity of the same amount. If unmarried retirees were allowed to name a non-spouse beneficiary without any reduction to their benefit, the plans' costs would increase by 0.29% of pay for the Highway Patrol and 0.54% of pay for the Judges as illustrated in the following tables.

	Highway Patrol	
	<u>Current Plan</u> <u>July 1, 2007</u>	<u>With Non-spouse</u> <u>Beneficiaries</u>
1. Actuarial accrued liability on July 1, 2007:	\$51,536,518	\$51,662,945
2. Assets at actuarial value (\$60,209,892 at market value):	\$48,167,914	\$48,167,914
3. Unfunded actuarial accrued liability - equals (1) minus (2):	\$3,368,604	\$3,495,031
4. Normal cost for ensuing year*:	\$1,304,356	\$1,313,224
5. Amortization payment - equals 20-year amortization of item (3) as a level percent of total payroll*:	\$235,096	\$243,919
6. Administrative expenses:	\$16,000	\$16,000
7. Total cost for ensuing year - equals (4) plus (5) plus (6):	\$1,555,452	\$1,573,143
8. Total payroll of covered members:	\$6,128,867	\$6,128,867
9. Total cost as percentage of payroll - equals (7) divided by (8):	25.38%	25.67%
10. Employee cost as percentage of payroll	10.30%	10.30%
11. Employer cost as percentage of payroll - equals (9) minus (10)	15.08%	15.37%

Judges

	<u>Current Plan July 1, 2007</u>	<u>With Non-spouse Beneficiaries</u>
1. Actuarial accrued liability on July 1, 2007:	\$23,121,548	\$23,252,320
2. Assets at actuarial value (\$33,487,664 at market value):	\$26,790,131	\$26,790,131
3. Unfunded/(Surplus) actuarial accrued liability - equals (1) minus (2):	(\$3,668,583)	(\$3,537,811)
4. Normal cost for ensuing year*:	\$959,032	\$975,498
5. Amortization payment - equals 20-year amortization of item (3) as a level percent of total payroll*:	(\$266,473)	(\$256,975)
6. Administrative expenses:	\$5,000	\$5,000
7. Total cost for ensuing year - equals (4) plus (5) plus (6):	\$697,559	\$723,523
8. Total payroll of covered members:	\$4,873,080	\$4,873,080
9. Total cost as percentage of payroll - equals (7) divided by (8):	14.31%	14.85%
10. Employee cost as percentage of payroll:	5.00%	5.00%
11. Employer cost as percentage of payroll - equals (9) minus (10):	9.31%	9.85%

* Adjusted for interest to recognize payments throughout the year.

2. Subsequent beneficiaries: Since the bill stipulates that the benefit is to be actuarially equivalent, the benefit should be reduced for a second time when the subsequent beneficiary is designated. If an actuarial reduction is made to the member's benefit upon designation of a subsequent beneficiary on a joint and survivor benefit, there will not be an actuarial cost for this provision.
3. Graduated benefit option: Since the monthly retirement benefit would be actuarially adjusted to provide for the post-retirement increases, there will not be an actuarial cost for this provision.
4. Eliminate 60-month certain optional form: For a certain group of surviving spouses, the 60-month certain form would be the death benefit with the highest actuarial present value. This is because the 60-month certain is subsidized for some surviving spouses based on their life expectancy. Therefore, if this form is eliminated, it may result in actuarial gains to the Hybrid Plan.
5. Additional service purchase amounts: Since the purchased service is not related to any eligible service, anyone can purchase up to ten years of service credit, rather than the current five-year limit. This means there is an increased risk of adverse selection compared to the existing service purchase provisions, because even though the purchase cost will be determined by actuarially equivalent factors, the individuals who decide to purchase credit may know how their own expected future service, salary, and lifespan compared to the average participant. The risk has been mitigated, to some degree, by

using appropriate assumptions in calculating the cost of the service purchase. It may be advisable for PERS to periodically review the appropriateness and accuracy of the assumptions used to calculate the cost of service purchases (e.g., every 5 years). Also, since the additional five years of service credit do not count towards Rule of 80 or Rule of 85 eligibility, the potential risk of adverse selection is less than it otherwise would have been.

6. The other provisions of the bill, including the make up of the State Investment Board and PERS Board, pre-tax employee contributions for the Highway Patrol Retirement System, and update to federal compliance statutory language, do not have an actuarial impact on the affected plans.

➤ Investment Impacts

- ◆ Asset Allocation: The bill does not create new investment asset allocation issues.
- ◆ Cash Flow Impacts: No impact.
- ◆ State Investment Board (SIB) Membership: The Board is proposing a change in the statute to allow one of its non-elected members to serve on the State Investment Board. This change is to allow the Board more opportunity to select from its membership those most interested in serving on the SIB while still maintaining the elected member representation.

Administration Issues

➤ Implementation Issues

To the extent any purchase of five years of additional service credit in the Hybrid Plan or Highway Patrol Retirement System is made with funds other than via trustee-to-trustee transfer from a defined contribution plan, the System must track the purchased service for limits on qualified and nonqualified service under Internal Revenue Code section 415(n).

➤ Administrative Costs

There may be administrative costs associated with setting up records for new beneficiaries in order to implement the proposed change to allow members to designate subsequent beneficiaries after the death of the original beneficiary or the divorce of the member. Trustee payment records would also have to be updated to reflect new beneficiaries. In addition, PERS may need to establish policies and procedures and develop forms in order to implement this proposed change (e.g, acceptable proof of death or divorce, restrictions on who may be designated as a beneficiary).

In order to implement the provision of the bill allowing an additional five years of service credit to be purchased, PERS would need to develop systems and processes for tracking service purchased for benefits purposes only and service towards retirement eligibility separately.

In order to implement the provision of the bill that provides a graduated increase in monthly retirement benefits of 1% or 2%, PERS would have to develop actuarial adjustment factors that take into account the age of the member at retirement and any other optional form elected. We provided details on how such adjustment factors should be developed in a separate letter.

If the 60-month certain option for surviving spouses is eliminated, PERS will no longer be required to offer a direct rollover for each of the 60 payments made under this form.

PERS' IT department has estimated the cost of programming the enhancements as follows:

Enhanced Purchase for Highway Patrol	\$22,500
Enhanced Purchase for PERS	\$22,500
Graduated Benefit Option Highway Patrol	\$27,500
Graduated Benefit Option PERS	\$27,500

Since PERS is replacing its existing business system, with the new system scheduled to be operational by January 2011, the above amount could be saved if the effective date of these provisions was on the same date. This would save adding functionality for the service purchase and graduated benefit option provisions to the old system for a short period of time.

➤ Needed Authority

In general, the bill appears to provide sufficient levels of administrative and governance authority to the PERS Board to implement the changes made by the bill. However, the provision of the bill that provides a graduated increase of 1% or 2% in monthly retirement benefits may need to be clarified to indicate the frequency of the increase (e.g., each year, every two years).

In addition, the provision of the bill that provides additional language to comply with Internal Revenue Code section 415(b) and related regulations, indicates that the dollar limitation will only be indexed effective the January 1st of each year following a regular legislative session, which occurs every two years. Therefore, the indexed dollar limitation for a non-legislative year will not apply until the following January, and consequently increases in monthly retirement benefits (e.g., the graduated benefit option or any ad-hoc cost-of-living increase) may not be able to be fully applied to the monthly benefits of certain members for a full year after permitted under the Internal Revenue Code rules.

➤ Cross Impact on Other Plans

No impact.

➤ Employee Communications

Employee communications will be necessary to explain the new beneficiary rules (both selection of a non-spouse annuitant for joint and survivor benefits and a subsequent


beneficiary after death or divorce); the graduated benefit option of 1% or 2% increase in monthly retirement benefits; the elimination of the 60-month certain option for surviving spouses in the Hybrid Plan; the rules regarding purchase of an additional five years of service credit unrelated to other eligible service; and the change from after-tax to pre-tax contributions for members of the Highway Patrol Retirement System and Judges retirement plan.

Please call if you have any questions or comments.

Sincerely,



Brad Ramirez, FSA, MAAA, EA
Consulting Actuary



Melanie Walker, JD
Vice President

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