2016 REGULAR SESSION
ACTUARIAL NOTE SB 10

Senate Bill 10 SLS 16RS-34 **Engrossed** **Author: Senator Barrow Peacock** **Date: March 30, 2016** **LLA Note SB 10.02** **Organizations Affected:** **Louisiana State Police Retirement System** **EG NO IMPACT APV**	**This Note has been prepared by the Actuarial Services Department of the Office of the Legislative Auditor. The attachment of this Note to SB 10 provides compliance with the requirements of R.S. 24:521** **Paul T. Richmond, ASA, MAAA, EA** **Manager Actuarial Services**

Bill Header: STATE POLICE RET FUND. Provides for the payment of certain administrative expenses. (6/10/16)

Cost Summary:

The estimated actuarial and fiscal impact of the proposed legislative is summarized below. Actuarial costs pertain to changes in the ***actuarial present value of future benefit payments***. A cost is denoted by "Increase" or a positive number. Savings are denoted by "Decrease" or a negative number.

Actuarial Cost to Retirement Systems	$0
Total Five Year Fiscal Cost	
Expenditures	$0
Revenues	$0

Estimated Actuarial Impact:

The chart below shows the estimated change in the ***actuarial present value of future benefit payments***, if any, attributable to the proposed legislation. A cost is denoted by "Increase" or a positive number. Savings are denoted by "Decrease" or a negative number. Present value costs associated with administration or other fiscal concerns are not included in these values.

Actuarial Cost to:	**Change in the Actuarial Present Value**
All Louisiana Public Retirement Systems	$0
Other Post Retirement Benefits	$0
Total	$0

Estimated Fiscal Impact:

The chart below shows the estimated fiscal impact of the proposed legislation. This represents the effect on cash flows for the retirement systems and other government entities. Fiscal costs include estimated administrative costs and costs associated with other fiscal concerns. A fiscal cost is denoted by "Increase" or a positive number. Actuarial or fiscal savings are denoted by "Decrease" or a negative number.

EXPENDITURES	**2016-17**	**2017-18**	**2018-19**	**2019-2020**	**2020-2021**	**5 Year Total**
State General Fund	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Agy Self Generated	0	0	0	0	0	0
Stat Deds/Other	0	0	0	0	0	0
Federal Funds	0	0	0	0	0	0
Local Funds	0	0	0	0	0	0
Annual Total	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0

REVENUES	**2016-17**	**2017-18**	**2018-19**	**2019-2020**	**2020-2021**	**5 Year Total**
State General Fund	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Agy Self Generated	0	0	0	0	0	0
Stat Deds/Other	0	0	0	0	0	0
Federal Funds	0	0	0	0	0	0
Local Funds	0	0	0	0	0	0
Annual Total	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0

<u>Bill Information:</u>

Current Law

The actuarially required employer contribution for the Louisiana State Police Retirement System (STPOL) is defined in R.S. 102(B)(3) as the sum of the following:

1. The employer normal cost,

2. The annual amortization payment necessary to amortize changes in unfunded accrued liabilities (UAL) occurring in prior years,

3. The annual amortization payment necessary to amortize the most recent year's over- or under-payment of employer contributions, and

4. The annual amortization payment necessary to amortize changes in UAL resulting from gains/losses, asset valuation method changes, changes in actuarial assumptions or funding methods, and benefit changes occurring over the most recent year.

The actuarially required employer contribution for the statewide retirement systems is defined as the sum of these same four elements *plus projected non-investment related administrative expenses* (see R.S. 11:103(B)(3)).

STPOL and its advisors concluded that projected administrative expenses cannot be directly included in the employer contribution calculation. Their rationale is summarized below.

1. The law pertaining to employer contribution requirements for STPOL is different from the law pertaining to the statewide systems.

2. Because the laws are written differently, the only reasonable conclusion is that the legislature in 1988 intended for the two contribution formulas to be different.

3. Because the contribution formula for STPOL does not mandate a cost component for administrative expenses, it is only reasonable to conclude that the legislature did not want STPOL to directly charge employers for administrative expenses.

SB 26, introduced during the 2014 regular session, contained provisions for all four state retirement systems that would have achieved the same result for STPOL as SB 10. Our actuarial note for SB 26 of the 2014 session contained a $50 million per year estimated fiscal cost. STPOL's share of this cost was estimated to be $574,000. In preparing this estimate, it was our understanding that annual administrative costs were being accounted for as an unending series of annual actuarial losses. After a meeting in the fall of 2015 with the actuaries of the state retirement systems, our understanding changed. It is now our understanding that administrative expenses are accounted for indirectly by the difference between what each system assumes it will earn on investments and the rate used to discount liabilities. For example:

1. STPOL assumes that it will earn 7.15% on the actuarial value of assets.

2. The system assumes that 15 basis points of the investment return will be used to offset administrative expenses.

3. The STPOL actuary calculates normal costs and liability values using a discount rate of 7.00% (7.15% - 0.15%).

4. Using this methodology, administrative expenses are recognized as they occur.

The actuary for the STPOL agrees that it would be more transparent to have a direct charge for administrative expenses rather than to continue to use the indirect method currently in use, particularly if the cost is the same.

Proposed Law

Under SB 10, indirect recognition of the cost of administrative expenses will be eliminated for STPOL and direct recognition will be implemented. The employer contribution components applicable to STPOL will then be identical to the components applicable to the statewide systems.

Implications of the Proposed Changes

If SB 10 is enacted, administrative expenses associated with STPOL would be accounted for directly as one of the components of the employer contribution calculation. Under current law, administrative expenses are accounted for indirectly.

<u>Cost Analysis:</u>

Analysis of Actuarial Costs

Retirement Systems

SB 10 contains no benefit provisions. Therefore, there are no benefit provisions having an actuarial cost.

Current Law

There are no actuarial costs associated with SB 10.

Other Post-Employment Benefits

There are no actuarial costs associated with SB 10 for post-employment benefits other than pensions.

Analysis of Fiscal Costs

There are no fiscal costs associated with SB 10.

SB 10 is identical to portion of SB 26 of the 2014 session applicable to STPOL. The actuarial note for SB 26 estimated the fiscal cost for STPOL to be about $574,000 per year. The fiscal cost for SB 5 of the 2016 session is estimated to be $0. Although SB 26 and SB 10 contain provisions that would achieve identical results for STPOL, the cost estimate has changed primarily our understanding of how administrative expenses are accounted for in the annual valuation has changed. An explanation is given below.

Estimated Fiscal Cost for SB 26 of the 2014 Session

Estimated fiscal costs for SB 26 were based on our understanding that administrative expenses were being treated as actuarial losses. The $574,000 annual fiscal cost for STPOL was developed in accordance with the following:

1. STPOL's share of the $50 million estimate was about $574,000.

2. STPOL assumes the return on the actuarial value of assets will be 7.15%. Or in other words, STPOL assumes that if it earns 7.15% on the actuarial value of assets, the system will not incur any gains or losses and administrative costs will be completely covered.

3. Because they are not able to directly charge employers with expenses under current law, STPOL indirectly charges employers by assuming actuarial earnings on investment will be 15 basis points less, or 7.00%.

4. The net rate, 7.00% (7.15% - 0.15%), is then used to discount all other future payments to obtain appropriate normal costs and actuarial present values.

5. It was our understanding in 2014 that administrative expenses were being accounted for by recognizing them as an unending stream of actuarial losses. Except for the fact that this method was proscribed by law, valuations prepared in this manner do not comply with actuarial standards of practice.

6. SB 26 would have put the STPOL's valuations into compliance with actuarial standards. However, such a correction would have increased annual fiscal costs by $574,000.

Estimated Fiscal Cost for SB 10 of the 2016 Session

Estimated fiscal costs for SB 10 are based our new understanding that administrative expenses are being recognized as an indirect annual charge to employers. The $0 annual fiscal cost estimate for STPOL was developed in accordance with the following:

1. If SB 10 is enacted, it would be actuarially incorrect to directly charge employers $574,000 for administrative expenses and also to indirectly charge employers a 15 basis point reduction in the assumed rate of return. This would result in a double charge for administrative expenses.

2. Directly charging employers $574,000 as required under SB 10 therefore requires that the 15 basis point charge be eliminated.

3. The discount rate would then be determined to be 7.15%.

4. Using a discount rate of 7.15% with a $574,000 direct charge for administrative expenses will produce valuation results that are generally equivalent to the use of a 7.00% discount rate with an indirect charge of 15 basis points (see information below relative to contemporaneous construction).

5. Therefore there no fiscal costs associated with SB 10.

Allowing administrative expenses to be funded by a continuous series of actuarial losses is contrary to actuarial standards of practice. Allowing administrative expenses to be indirectly funded complies with actuarial standards, but is not the method most preferred by actuarial professionals. The most acceptable method under actuarial standards of practice is to directly charge for administrative expenses on an annual basis. SB 10 complies with the most acceptable practice.

It is our understanding that the STPOL board of trustees will not increase the discount rate to 7.15% if SB 10 is enacted and the indirect charge is eliminated. The STPOL board may choose not to increase the discount rate 7.15% in order to align their system with future expected earnings. The effect of a board choosing not to increase the discount rate would put upward pressure on employer contribution requirements. Such a decision by the board, however, is outside the scope of this actuarial note as is the cost associated with such a decision.

It is our understanding that STPOL currently calculates investment gains or losses without regard to administrative expenses. In other words, an investment gain or loss includes returns that are going to be used for administrative expenses. As a result, gains are larger than what they would be should gains be reduced for administrative expense and losses would be smaller than what they would be otherwise. STPOL supports this practice by relying on a legal theory of *contemporaneous construction.* When retirement laws were originally enacted in the late 1980s and early 1990s, no direct guidance was provided on how to account for administrative expenses. With the lack of such guidance, STPOL took a position on administrative expenses and investment gains and losses that has been used ever since. The *contemporaneous construction* theory asserts that given no guidance originally, the adoption of an administrative process in the absence of guidance and with the passage of time, the procedures originally established actually become law and therefore cannot be changed without legislation.

The end result of the application of the *contemporaneous construction* theory is that more funds become available for transfer to the Experience Account and for future disbursement to retirees in the form of COLA benefits. Again, it is our understanding that STPOL contends that this is a benefit right that cannot be taken away.

SB 10 does not address, change, or override the contemporaneous construction theory. Therefore, the *contemporaneous construction* theory and any adjustment thereto are outside the scope of SB 10.

Actuarial Data, Methods and Assumptions

This actuarial note was prepared using actuarial data, methods, and assumptions as disclosed in the most recent actuarial valuation report approved by PRSAC. These assumptions and methods are in compliance with actuarial standards of practice. This data, methods, and assumptions are being used to provide consistency with the actuary for the retirement system who may also be providing testimony to the Senate and House retirement committees.

Actuarial Caveat

There is nothing in SB 10 that will compromise the signing actuary’s ability to present an unbiased statement of actuarial opinion.

Actuarial Credentials:

Paul T. Richmond is the Manager of Actuarial Services for the Louisiana Legislative Auditor. He is an Enrolled Actuary, a member of the American Academy of Actuaries, a member of the Society of Actuaries and has met the Qualification Standards of the American Academy of Actuaries necessary to render the actuarial opinion contained herein.

Dual Referral:

Senate	**House**
☐ 13.5.1: Annual Fiscal Cost ≥ \$100,000	☐ 6.8(F)(1): Annual Fiscal Cost ≥ \$100,000
☐ 13.5.2: Annual Tax or Fee Change ≥ \$500,000	☐ 6.8(F)(2): Annual Revenue Reduction ≥ \$100,000
	☐ 6.8(G): Annual Tax or Fee Change ≥ \$500,000