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CONSULTING, LTD.

November 14, 2022

Board of Trustees
Firefighters' Retirement System
P.O. Box 94095
Baton Rouge, Louisiana 70804

Re: Answer to questions received regarding COLAs

Gentlemen:

The retirement system received questions from Jill Folks, the daughter of a retired Shreveport firefighter, related to her concerns that her father and other firefighters have not received a consistent COLA raise. In her initial email sent to the system's Executive Director, Steven Stockstill, she asked if 3% is a large amount of money based on what firefighters were making when they retired.

When we discussed the COLA decision with the HR136 Committee, we found that within the 2021 valuation there were 2,578 retirees and survivors and 2,518 of them would be retired at least 1 year as of January 1, 2022. To provide a 3% COLA based on the current benefit of each of these 2,518 recipients would result in an additional $3,143,105 in benefits per year. Since such a COLA would be payable for the lifetime of each of these recipients, the total increase in system liabilities is much larger. We estimated the present value of a 3% cost-of-living increase to be $32,458,618. The total cost of such a COLA represents 12.61% of the projected payroll for the entire active membership of the system based on the data contained within the fiscal 2021 valuation. Employers would not be asked to pay for a COLA in a single year. Instead, they would see an increase to their required contribution rate spread over the future working lifetime of current members. This would have resulted in an increase to the employer contribution rate of 1.17% of payroll for the foreseeable future.

Ms. Folks' question is similar to questions we have heard from stakeholders in the past. She stated, "Is 3% a large amount of money based on what men my dad's age were making at the time they retired, certainly not, BUT it is also the principal and moral obligation that is owed to these men and women." The Board of Trustees and the HR136 Committee have both expressed agreement that providing COLAs to retirees is an important goal. The challenge has been dealing with the cost increase given the current funding requirements. When someone looks at their family member's annual benefit (say $40,000) and sees that a 3% COLA would add $1,200 per year to costs and then sees plan assets near $2 billion, they typically feel that offering the COLA should be affordable. Plan assets of nearly $2 billion is a lot of money, but the accrued liability for already promised benefits to current active members, current terminated vested former members, and to retirees and survivors is larger. This means that employers are already on the hook for additional contributions just to make sure that the system can keeps its promise to provide current benefits.

In a follow up email sent to my attention, Ms. Folks asked, "Why is there no money in the account that funds these increases?" I believe that Ms. Folks is asking why there is no money in the

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system's Funding Deposit Account, although R.S. 11:107.1(D)(4)(c) states that FRS may not provide for COLAs with funds charged from this account. R.S. 11:107 provides the Firefighters' Retirement System limited opportunity to require employers to pay an annual employer contribution rate that exceeds the amount required to actuarially fund benefits already promised. The statute states that in any fiscal year during which the net direct employer contribution rates would otherwise be decreased the board of trustees is authorized to set the employer contribution rate at any point between the previous year's employer contribution rate and the decreased rate. Per R.S. 11:107.1, any "surplus funds collected by the system shall be credited to the system's funding deposit account. FRS was added to the Funding Deposit Account section in the 2016 regular legislative session. This means that the first year in which the system had the right to set the employer rate higher if it was scheduled to decrease was fiscal 2018 which was set by the 2016 actuarial valuation.

| Fiscal Year of Report | Fiscal Year of minimum employer rate | Minimum Employer Rate Set by Valuation | Employer Rate set according to R.S. 11:107 | Surplus funds generated |
|---|---|---|---|---|
| 2016 | 2018 | 26.50% | N/A | N/A |
| 2017 | 2019 | 26.25% | 26.50% | $0 |
| 2018 | 2020 | 27.75% | N/A | N/A |
| 2019 | 2021 | 32.25% | N/A | N/A |
| 2020 | 2022 | 33.75% | N/A | N/A |
| 2021 | 2023 | 33.25% | N/A | N/A |
| 2022 | 2024 | 32.50% | Not determined yet | Not determined yet |

The only opportunity afforded the Board of Trustees to hold the employer rate above the minimum since the law passed in 2016 was after the 2017 actuarial valuation was approved. The minimum employer rate had dropped by 0.25% and the Board of Trustees elected to hold the rate at the 26.50% rate in effect from the prior valuation. Unfortunately, this 0.25% employer rate difference did not generate surplus funds.

At a recent HR 136 committee meeting, we discussed the reasoning for the lack of surplus funds generated by the decision of the Board to hold the 2019 rate above the minimum rate of 26.25% by 0.25%.

An excerpt from our 2018 actuarial valuation discusses this issue:

"The Fiscal 2017 actuarial valuation set a minimum recommended net direct employer contribution rate for Fiscal 2019 at 26.25%. Pursuant to R.S. 11:107, the Board of Trustees elected to maintain the Employer Contribution Rate at 26.50% (the net direct employer contribution rate for Fiscal 2018). Since the Net Direct Actuarially Required Employer Contribution Rate for Fiscal 2019 is 28.32% the system is projected to have a contribution loss despite the collection of extra contributions. Therefore, no funds were added to the system's Funding Deposit Account."

After the Board's decision to hold the rate above the minimum, required costs grew significantly (due to investment experience below expectations, the lowering of the assumed rate of return in order to remain within the system's reasonable range, and a contribution loss). Therefore, holding the rate higher helped to offset the deficit in costs but did not result in surplus funds.

At the December 2022 meeting, we will discuss the Board's options with regard to the Funding Deposit Account as a result of the 2022 valuation. As shown above, the minimum employer contribution rate for Fiscal 2024 is lower than the employer contribution rate in effect for Fiscal 2023 (or 33.25%). Therefore, it is possible that the Board could cause funds to be added to the Funding Deposit Account in the next few years.

Ms. Folks also asked, "Was there not a "rainy day" amount set up for interest rate fluctuations?" The simple answer to this question is that prior to the 2016 legislative session, FRS did not have any statutory authority to set aside funds in a "rainy-day fund". The legislation adding FRS to the Funding Deposit Account in 2016 first created a "rainy-day fund" for use in future years. As discussed above, no money was added to this side fund during the period since its passage through today. This has resulted due to increases in the minimum employer contribution rate over this period. Funding for such "rainy-day" funds typically comes in years where costs are down and employers can afford to set aside additional funds to reduce the risk of large cost increases in the future. FRS has simply not had the right circumstances since the law's passage to put funds aside.

Ms. Folks also asked, "If there was an approximate $7 million gain, why could those funds not be used to provide "something" for the firefighters?" I am unaware where Ms. Folks found a $7 million gain figure, but I can answer the concept of using gains to fund COLAs. Since many equate investment gains with an ability to provide COLA funding, I will begin there. The following chart shows investment gains and losses over the past seven years:

| Fiscal Year | Market Rate of Return | Actuarial Rate of Return | Assumed Rate of Return | Amount of Investment Gain or Loss | Gain or Loss |
|---|---|---|---|---|---|
| 2016 | -2.3% | 3.1% | 7.5% | $ 65,389,778 | Loss |
| 2017 | 13.6% | 5.7% | 7.4% | $ 27,265,283 | Loss |
| 2018 | 6.5% | 5.6% | 7.3% | $29,194,603 | Loss |
| 2019 | 4.4% | 4.5% | 7.3% | $48,181,781 | Loss |
| 2020 | 3.1% | 4.9% | 7.15% | $41,034,295 | Loss |
| 2021 | 26.1% | 9.9% | 7.00% | $54,762,380 | Gain |
| 2022 | -10.9% | 5.7% | 6.90% | $24,994,370 | Loss |

As you can see, over the most recent 7 years the system has exceeded its assumed rate of return twice on a market rate of return basis, but only once on an actuarial rate of return basis. In truth, only the actuarial rate of return comparison actually matters in the determination of the minimum actuarially determined employer contribution rate. As you can see, although the retirement system might experience an investment gain in a singular year, the system also experiences years with investment losses. Each gain serves to reduce the minimum actuarially required employer contribution rate and each losses serves to increase it. If costs are allowed to increase in loss years without offset from gain years, the system could be expected to see even higher employer costs.

To "use" investment gains to "fund COLAs" would simply require employer contribution rates to increase to replace those funds. Another thing to consider is that the most recent measure of funded ratio shows that the system is 80.41% funded. This means that the actuarial value of assets currently only covers 80.41% of already "promised" benefits. Adding liabilities for COLAs without adding assets in the form of additional funding simply means that the current benefits are less secure. The granting of COLAs (which increases promised benefits) should not be decided based on gains which can be temporary and cyclical. It is for this reason that the HR136 Committee is recommending a change in approach to funding future COLAs. The only way to fund a COLA without causing an increase in the long-term required employer contribution rate is to prefund it by collecting truly excess contributions when possible and only granting that extra benefit when sufficient funds are set aside.

Ms. Folks' next question related to the makeup of the Board of Trustees. I have not attempted to answer this question since the system's Executive Director indicated his intention to answer this particular question.

Finally, in Ms. Folks' email, she made the following statement: "With all due respect, it appeared from listening to the meetings that many on the board are not confident in what can or cannot be done according to the law and appears there are options available if you are willing to move on them. For everyone not to be educated on what can and can't be done is somewhat disrespectful for those of us fighting for the respect these firefighters deserve. I pray my dad is here for another 10 plus years, but it appears whether he is or is not, he still will not see this in his lifetime."

I wish any of us could say when the system would be able to provide retirees and survivors with a well-deserved cost-of-living increase. As the HR136 Committee has discussed for the past few months, the limiting factor in providing COLAs is funding. Unfortunately, the only practical option presented by retirees has been to increase the assumed rate of return from 6.9% back to 7.0% in order to "afford" a COLA. This suggestion was made based on the information provided in our fiscal 2021 valuation report that showed that the impact of the change in valuation interest rate increased the employer contribution rate by 1.6638% while the cost of a 3% COLA would have increased the employer contribution rate by 1.17%.

As we have discussed in our Board meetings, although the Board of Trustees could legally increase the assumed rate of return to the previous 7% level and thereby decrease to the minimum actuarially required employer contribution rate, this would place this important assumption even closer to the top end of the reasonable range. I cannot recommend such a decision since, according to the latest completed study of the assumed rate of return, even the 6.9% assumption is above the midpoint of the reasonable range. The Board has spent a tremendous amount of time discussing this important assumption. Changes have been made to the assumed rate of return in increments meant to spread out the impact of the changes. All of these efforts have lowered the risk being taken by the retirement system. The security of retiree benefits depends upon setting a reasonable assumption. No one knows what the FRS portfolio will earn in the future, but we have developed the reasonable range for the assumed rate of return based on professional opinions about future expected returns and volatility for the FRS target asset allocation. A decision to increase the assumed rate of return and to provide a COLA that has not been prefunded might feel good initially since the employer contribution rate might even decrease.

I think we can all agree that the system's future costs must increase if retiree benefits are increased. (We estimate that the present value of these additional benefits totals $32.5 million). An attempt to "pay" for this through a change in assumption necessarily adds risk. Assuming a higher future return lowers the employer cost because if the system earns more from investments, it will need less from employers. But, if nothing is actually done to change future investment returns, the change of assumption simply adds risk that the system's employer rate will increase in future years to replace unrealized investment returns.

As I finish answering the questions posed in Ms. Folks' email, I wish to say that I do have great empathy for the system's retirees and survivors. I recognize that without increases in benefits, retirees who depend solely on their benefit check from FRS face diminished buying power. The State of Louisiana through its statutes and State Constitution has provided a meaningful level of security to the promised benefits for FRS retirees. Unfortunately, neither the statutes nor Constitution provide any guarantee of cost-of-living increases. Circumstances led to frequent COLAs in the early years of the system. COLAs had a significantly lower cost and minimum employer rates were below the minimum level of 9%. The decision to grant a COLA prior to 2000 came with no direct impact to the employer rate paid and so COLAs were granted with great frequency. Since 2000, significant cost pressures have faced the system and circumstances have limited the availability of COLAs.

Unfortunately, our projections for FRS include expectations of higher employer contribution rates in the coming years unless the system experiences meaningful investment gains to offset recent losses. This is expected to place a greater fiscal burden on already struggling municipalities and fire districts and unless the State Legislature is willing to provide direct funding for a COLA will likely make the prospect of a COLA less likely in the near term.

If you have any questions, please do not hesitate to call.

Sincerely,

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