

Briefing on Principles and Guidelines for Public Employee Retirement Systems
Prepared for the State Administration and Veterans' Affairs Interim Committee
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January 2012

Section 5-5-228, MCA, outlines the State Administration and Veterans' Affairs Interim Committee (SAVA) duties. One of SAVA's responsibilities is to establish principles of sound fiscal and public policy. These principles are to be used as guidelines for considering the actuarial and fiscal soundness of the state's public employee retirement systems and as a benchmark against which the Committee, the Legislature, public employees and other stakeholders, taxpayers, and the general public can measure proposed changes to Montana's retirement systems.

History of SAVA Principles and Guidelines

SAVA Committees (and precursors to the SAVA Committee) have updated and adopted these principles through the years. The 2009-2010 SAVA Committee adopted the following principles, which are identical to the principles adopted in the previous two interims:

PRINCIPLES¹

- I. Pensions should provide the base of financial security in retirement.
- II. Pension funding should be a contemporary obligation.
- III. Pension investments should be governed by the Prudent Expert Rule.
- IV. Pension benefits should be equitably allocated among beneficiaries.

These principles have their origin in work done by the National Conference of State Legislatures Working Group on Pensions, which was part of the larger Fiscal, Oversight and Intergovernmental Affairs Committee in the 1980s and 1990s. Previous SAVA Committees have amended the principles to align with their goals for and views of the Montana retirement systems, but the four principles are similar to those originally established.

The principles can be thought of as SAVA's answers to four fundamental questions about public retirement systems:

- What purpose should pensions serve?
- Who should fund public pensions?
- What standards should govern investment of pension assets?
- How should pension benefits be allocated among beneficiaries?

¹The information in this section of the report comes from a document prepared by Rachel Weiss, Legislative Services staff, for the 2009-2010 SAVA Committee: Rachel Weiss, "Briefing Paper: Principles and Guidelines for Public Employee Retirement Systems," October 30, 2009. That briefing cites: *Public Pensions: A Legislator's Guide*, National Conference of State Legislatures, The NCSL Working Group on Pensions of the Fiscal, Oversight and Intergovernmental Affairs Committee, July 1995.

Principle I: Pensions should provide the base of financial security in retirement.

Principle I originally read "Pensions should provide financial security in retirement." In 1998, the Committee on Public Employee Retirement Systems added "the base of" to the principle, thus amending the meaning. Essentially, this principle states that at the end of a working career (not just employment), a pension from an employer should provide a source of some (but not all) of the retirement income a person will need to have financial security, with "financial security" meaning a floor of benefits.

Principle II: Pension funding should be a contemporary obligation.

Principle II states that funding pensions is the obligation of the public employers, employees, and people receiving the services provided by the public employees at the time those services are provided. It means that the cost of providing pensions for current workers should not be deferred to future taxpayers. Contribution amounts should be set with consideration of what tomorrow's costs will be to provide a benefit to today's public worker.

This principle contrasts with a "pay-as-you-go" system, in which retirement benefits are paid for after the worker has retired and the benefits have been earned, a type of system rare in public retirement plans. It also discourages "ad-hoc" increases that add to an employee's benefit without a corresponding increase in contributions from the employer or the employee to cover the cost of providing the increased benefit.

Principle II also doesn't mean that the existence of an unfunded liability in a defined benefit plan is necessarily problematic. Built into a plan's actuarial assumptions is the idea that earnings from the investment of the employer and employee contributions -- and investment earnings on previous earnings -- will contribute to funding retirement benefits. Over a set period of time, these three elements -- employer and employee contributions and investment earnings -- should combine to pay off the cost of the current workers' future benefits as currently defined, thus meeting the standard that pension funding should be a contemporary obligation. Section 19-2-409, MCA, sets out this time period as no more than 30 years.²

Principle III: Pension investments should be governed by the Prudent Expert Rule.

Principle III sets the standard for how pension assets should be invested. It was modified from the original language ("prudent person") to mirror language added in 1994 by Constitutional Amendment No. 25 to Article VIII, section 13(3), of the Montana Constitution. This subsection requires retirement system assets "to be managed in a fiduciary capacity in the same manner that a prudent expert acting in a fiduciary capacity and familiar with the circumstances would use in the conduct of an enterprise of a similar character with similar aims." The language in the Montana Constitution is similar to the language Congress set to govern the standard of care for fiduciaries in the Employment Retirement Income Security Act of 1974

²Article VIII, section 15, of the Montana Constitution requires retirement systems to be funded on an "actuarially sound basis." Section 19-2-409, MCA, clarifies the meaning of this requirement, saying that "'actuarially sound basis" means that contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. For a defined benefit plan, the full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing the unfunded liability over no more than 30 years. For a defined contribution plan, the full actuarial cost is the contribution defined by law that is payable to an account on behalf of the member."

(ERISA) in what is called the "Prudent Investor Rule." All 50 states use some version of this rule to govern the investment of their pension assets.

Principle IV: Pension benefits should be equitably allocated among beneficiaries.

Generally, this principle can be followed simply by keeping retirement plans compliant with Internal Revenue Service (IRS) guidelines. Regulations exist to prevent discrimination between employees based on age or earnings. A state's retirement plan should not discriminate against those who earn less or start late. The NCSL Working Group also advises ending provisions that "unreasonably differentiate" between groups of employees, giving latitude for different retirement plans to have different formulas for determining benefits, depending on the rationale behind the formula. This principle also covers the areas of portability and vesting, issues which most Legislatures have worked hard to address.

GUIDELINES

The guidelines provide additional detail and standards to assist the Legislature when providing general oversight of the state's retirement systems and reviewing any proposed changes to those systems. As with the principles, they can be amended, deleted, or supplemented with new guidelines at the discretion of the Committee.

The guidelines have changed little over the past three interims. The 2009-2010 SAVA adopted 23 guidelines, one fewer than those tentatively adopted by the 2007-2008 SAVA. The guideline dropped by the 2009-2010 SAVA stated, "The legislature should provide for an annual increase in postretirement benefits."

The guidelines adopted by the 2007-2008 SAVA similarly differed little from those adopted by the 2005-2006 SAVA. There were two slight changes:

- The language in guideline (L), related to requiring annual actuarial reports that use uniform actuarial assumptions, was changed from "The legislature should move toward requiring..." to "The legislature should continue to require..."
- The guideline addressing the Firefighters' Unified Retirement System was changed from "The legislature should authorize local governments to enroll rural firefighters..." to "The legislature should continue to authorize local governments to enroll rural firefighters..."

Other States

This section reviews principles or guidelines adopted for public retirement systems adopted by other states. Nebraska, like Montana, has a set of retirement principles that are regularly revisited and updated as necessary. Iowa codified guiding goals in statute and the Washington Select Committee on Pension Policy developed "Goals for Washington State Public Pensions."

Iowa

In Iowa, the Legislature outlined guiding goals for future changes in public retirement systems in state law. The statute was enacted in 1998.

97D.1 Guiding goals for future changes in public retirement systems — social security — portability.

1. The general assembly declares that legislative proposals for changes in specific public retirement systems should be considered within the context of all public retirement systems within the state, with emphasis on equity and equality among the systems. The following list of guiding goals shall apply to the consideration of proposed changes:
 - a. Select those benefit enhancement options which most successfully deliver the greatest good to the greatest number of employees.
 - b. Choose those options which best correct existing inequities between and among the various retirement groups in the state.
 - c. Determine those options which most ably serve the twin objectives of attracting and retaining quality employees.
 - d. Avoid enacting further incentives toward earlier retirement with full benefits.
 - e. Avoid further splintering of benefits by disproportionate enhancement of benefits for one group beyond those available to another.
 - f. Avoid enacting further benefit enhancements that fail to preserve or enhance intergenerational equity amongst all employees covered by the retirement system.
2. The public retirement systems committee established by section 97D.4 shall periodically weigh the advantages and disadvantages of establishing participation in the federal social security system for the members of public retirement systems operating under chapters 97A and 411 and the impact of such a change on total contributions and benefits.
3. The public retirement systems committee established by section 97D.4 shall consider proposals to achieve greater portability of pension benefits between the various public retirement systems in the state. Special attention should be given to the actuarial cost of transfers of value from one system to another.

Nebraska

The Nebraska Retirement Systems Committee (Committee) conducted a study to review and update the General Principles of Sound Retirement Planning in 2010. The Committee uses the General Principles of Sound Retirement Planning to evaluate proposed legislation and issues regarding Nebraska's public retirement systems. The Legislature also uses the General Principles as a guide on the state's retirement systems. The General Principles were developed in the 1970s and revised in the 1980s, 1996, and 2006. The General Principles are intended to be reviewed and updated, if necessary, every five years.

The Committee held an interim hearing in September 2010 to discuss amending the General Principles of Sound Retirement Planning. The changes adopted as a result of the hearing were of two types: the insertion of language to reflect the 2002 adoption of a cash balance plan for new county and state employees and clarifying or cleanup language.

The Nebraska General Principles of Sound Retirement Planning are more detailed than the

Montana Principles and Guidelines for Public Employee Retirement Systems. The principles are grouped into seven topics and each principle within the seven topics contains a set of comments that further explains the principle. The principles are provided below without the comments.³

I. Application of the General Principles & Evaluation of Legislation.

I. A. The Legislature has the responsibility of developing sound and adequate public retirement systems for Nebraska public employees. The Nebraska Retirement Systems Committee has developed and will periodically review the General Principles of Sound Retirement Planning ("General Principles"). The principles will be applied to any state administered public retirement system as well as public retirement systems specifically provided by statute. Other public retirement systems administered by political subdivisions and generally provided in statute should utilize the principles as guidelines.

I. B. All proposed changes in retirement systems should be measured against these General Principles.

I. C. All proposed legislative changes in retirement systems must be actuarially sound and supported by an actuarial study, if necessary, to evaluate the cost of the proposal and the fiscal impact on the State of Nebraska.

II. Retirement System Objectives.

II. A. When possible, retirement provisions should be added, amended or deleted uniformly or consistently among the various public retirement systems covering different groups of public employees.

II. B. Each employee authorized to participate within a retirement system should be treated equitably and without discrimination.

II. C. Retirement plans should be designed to provide adequate retirement benefits for employees who complete a period of service considered to be a normal career. Benefit adequacy should be based upon the income replacement needed to maintain the same standard of living during retirement as before retirement. Sources of income replacement should include the base retirement benefit under the public system, the Social Security benefit if earned during employment covered by the plan, and assumed voluntary savings.

II. D. In determining benefit adequacy, Social Security benefits should be taken into consideration for employment covered under the public plan. Changes in social security benefits may require revisions to the base benefits provided under the public plan.

II. E. For groups covered under Social Security, auxiliary benefits in the retirement system,

³A link to the complete General Principles of Sound Retirement Planning with comments can be found on the [SAVA website](#), the Nebraska Retirement Systems committee reports [website](#), or requested from SAVA staff.

such as death and disability benefits, are incidental and should not be a major portion of the total benefit package.

II. F. Base retirement benefits provided by a public employer should be provided directly under the retirement system.

III. Funding of the Retirement System.

III. A. All public retirement systems, including those in the political subdivisions, should be pre-funded according to sound actuarial principles, and benefits should not be paid out of current revenues.

III. B. Unfunded liabilities are to be amortized so as to reduce the unfunded liability to zero in 30 years, or less, from the date the liability is identified by the actuary. Long-term costs and the amortization of unfunded liabilities should maintain generational equity.

III. C. Each retirement system should be funded so that the actuarial present value of assets will be equal to 90%-110% of the Projected Benefit Obligation (PBO).

III. D. Prior to adopting additional benefit enhancements for a defined benefit plan, a reasonable reserve amount should be established with the plan in order to reduce the need to make future required actuarial contributions during periods when actual investment returns are less than the actuarially assumed rate of investment returns. If such reserve does not exist at the time a benefit enhancement is proposed, then a required reserve amount or percentage should be implemented in conjunction with the adoption of the benefit enhancement.

IV. Retirement System Design.

IV. A. Reasonable eligibility requirements are a part of any well-designed retirement system.

IV. B. Member contributions should be established at a rate so that a new employee entering at age 35 or under will pay no more than 50% of the total contributions to his or her plan.

IV. C. Vesting provisions should be included in the various retirement systems.

IV. D. Employees who continue their employment beyond the normal age of retirement should continue to participate in the retirement systems.

IV. E. Optional forms of benefit payments should be available at retirement and calculated as actuarial equivalents to the normal form of benefit.

IV. F. All early retirement benefits should be reduced due to the longer period of benefit payments.

IV. G. Transferability of credits among the various retirement systems should be provided to the

extent transfers are legally and financially possible.

V. Revisions in Plan Design.

- V. A. Future liberalizations in benefits under existing systems may be made for service both prior to and subsequent to the date of improvement for active members under a defined benefit plan. For members who have retired under either a defined benefit, or a defined contribution, or cash balance plan prior to enactment of legislation, only cost-of-living adjustments may be made.
- V. B. The employer should pay a greater portion, if not all, of the cost of any past service benefit.
- V. C. Buy-back provisions may be appropriate for purchasing credit for specified periods of service. All buy-back proposals should be evaluated on the following: (1) The buyback provision should not provide a significant indirect or unintended subsidy to the employee buying the service at the expense of continuing members; (2) Buy-back opportunities should not be expanded without an actuarial fiscal note of the likely cost of a provision; (3) Any "discount" to the expected cost of a buy-back provision should be disclosed and taken into account in the actuarial valuation of the system; (4) The buy-back provision should not allow purchase of service credit if another benefit will be provided for the same period of service; and (5) The experience of the buy-back provisions should be monitored so that adjustments can be made as necessary to the contributions required of employees.
- V. D. Cost-of-living adjustments should be provided to maintain benefit adequacy during post-retirement inflation. When possible, any specific recognition of changes in the cost of living in plan provisions should be made on a uniform basis for all systems.
- V. E. Proposals to divide or fragment a retirement system, or provisions under a retirement system, should be evaluated upon the following: (1) Increased costs and/or inefficiencies; (2) Qualification concerns under federal law; and (3) Real need for disparate treatment of an identified class of employees.

VI. Retirement System Administration.

- VI. A. All retirement systems should be designed and administered in compliance with state law, the Internal Revenue Code and the associated regulations, other federal law, and generally accepted accounting principles.
- VI. B. Administration of the various systems should be performed by a qualified board and qualified staff. The board should administer the system solely in the interests of the members and beneficiaries of the retirement systems for the exclusive purposes of providing benefits to members and members' beneficiaries and defraying reasonable expenses incurred. The board should include employee representatives.

- VI. C. Each public retirement system should submit an annual report to the appropriate governing body. For state-administered plans, the annual report should be submitted to the Legislature and the Governor.
- VI. D. Each public defined benefit retirement system should have periodic actuarial valuations of the pension assets performed by an independent actuarial consulting firm.
- VI. E. Each retirement system should be independently reviewed by a professional consultant, with expertise in public pension plans.
- VI. F. Each public retirement system should communicate with the members of the system and inform them of any developments at the state or federal level affecting the benefits or provisions of their retirement system.
- VI. G. Comprehensive retirement planning should be available to all public employees.

VII. Investment of Pension Funds.

- VII.A. The statutes should allow the flexibility to pursue a prudent investment policy that will maximize investment yields consistent with sound investment principles. Investments should be made solely in the interests of the members and beneficiaries of the retirement systems for the exclusive purposes of providing benefits to members and members' beneficiaries and defraying reasonable expenses incurred. No retirement funds should be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives. Investment of state administered retirement funds should be consolidated in an entity with expertise in investing.
- VII.B. Return on investment of retirement funds should be independently reviewed by a professional consultant, with expertise in the area, every five years to see that they are being maintained on an adequate, sound and consistent basis.

Washington

The Select Committee on Pension Policy is tasked with studying pension issues, studying the financial condition of pensions, developing pension policies for public employees in state retirement systems, developing funding policies, and making recommendations to the Legislature.⁴ The Select Committee is comprised of members of the Legislature, active members of the state retirement systems, retired members of the state retirement systems, employers of members of the state retirement systems, and directors of the Department of Retirement Systems and the Office of Financial Management.⁵

The Select Committee revised and adopted "Goals for Washington State Public Pensions" on

⁴Revised Codes of Washington 41.04.281

⁵Revised Codes of Washington 41.04.276

September 27, 2005.⁶ Those goals are reproduced below:

Goals for Washington State Public Pensions (Revised and Adopted September 27, 2005)

1. Contribution Rate Setting: To establish and maintain adequate, predictable and stable contribution rates, with equal cost-sharing by employers and employees in the Plans 2, so as to assure the long-term financial soundness of the retirement systems.
2. Balanced Long-Term Management: To manage the state retirement systems in such a way as to create stability, competitiveness, and adaptability in Washington's public pension plans, with responsiveness to human resource policies for recruiting and retaining a quality public workforce.
3. Retirement Eligibility: To establish a normal retirement age for members currently in the Plans 2/3 of PERS, SERS, and TRS that balances employer and employee needs, affordability, and flexibility, and the value of the retirement benefit over time.
4. Purchasing Power: To increase and maintain the purchasing power of retiree benefits in the Plans 1 of PERS and TRS, to the extent feasible, while providing long-term benefit security to retirees.
5. Consistency with the Statutory Goals within the Actuarial Funding Chapter: To be consistent with the goals outlined in the RCW 41.45.010:
 - a. to provide a dependable and systematic process for funding the benefits to members and retirees of the Washington State Retirement Systems;
 - b. to continue to fully fund the retirement system plans 2 and 3, and the Washington State Patrol Retirement System, as provided by law;
 - c. to fully amortize the total costs of PERS 1, TRS 1, and LEOFF 1, not later than June 30, 2024;
 - d. to establish predictable long-term employer contribution rates which will remain a relatively predictable portion of future state budgets; and
 - e. to fund, to the extent feasible, benefit increases over the working lives of those members so that the cost of those benefits are paid by the taxpayers who receive the benefit of those members' service.

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⁶Select Committee on Pension Policy, "Goals for Washington State Public Pensions," <http://www.leg.wa.gov/SCPP/Documents/GoalsAdopted.pdf>.

