

**Issues Pertinent to HJR 42
and
Montana Public Employee Retirement Systems**
A Discussion Paper
for the State Administration and Veterans' Affairs Interim Committee

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INTRODUCTION

Between July 2004 and January 2005, as the full effect of the implosion of the nation's financial markets that occurred between January 2000 and October 2003 began to manifest in the state's public employee retirement systems and elsewhere, policymakers in the executive and legislative branches of Montana state government gradually became aware of challenges that were all but inconceivable only a few years before.

Nearly every observer of the nation's financial markets had witnessed the miracle of the U.S. stock markets in the mid- to late-1990s when, for example, the S&P 500 experienced annual increases that averaged nearly 26%.¹ During those heady days, it was very difficult for most pundits and investors, Alan Greenspan excluded,² to foresee that the "irrational exuberance" that the financial markets were experiencing would not only contract significantly, but also that the contraction would have far-ranging ripple effects, first through corporate America in the form of bankruptcy and scandal and eventually through many individuals' and pension plans' invested assets.

Like many other states, private entities, and individuals that rely on financial markets as the foundation for funding their respective retirement plans, Montana was not immune to the siren's song of what, in hindsight, were clearly unsustainable investment returns. As a result of legislation, House Joint Resolution No. 42 specifically, adopted by the 59th Legislature, the State Administration and Veterans' Affairs Interim Committee (SAVA) spent countless hours, individually, and the better part of five committee meetings examining options for mitigating the effects of losses in public pension asset values. The bulk of that work was completed in November 2005 with the SAVA's

¹ Derived from figures presented by Carroll South, Executive Director, Montana Board of Investments, in memorandum to Board [of Investments] Members, February 17, 2006. "From Fiscal Years 1995 through 1999... large cap stock as represented by the S&P 500 Index returned 26.07, 26.00, 34.70, 20.16, and 22.76 percent respectively."

² From remarks by Federal Reserve Chairman Alan Greenspan at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Washington, D.C., December 5, 1996: "Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

endorsement of legislation³ to restore actuarial soundness to the state's four ailing public employee retirement systems.⁴ However, many of the issues identified in HJR 42 remain to be resolved and there are numerous other retirement-related matters that the SAVA could investigate if the members choose to do so.

The remainder of this paper seeks to identify a range of issues that the SAVA or others may wish to investigate. In Part I are issues that some observers may see as integral to HJR 42. In the subsequent Part II are adjunct issues that stand alone as matters relevant to public employee retirement systems and that may of interest in their own right to the Committee.

PART I: MITIGATING THE UNFUNDED ACCRUED ACTUARIAL LIABILITIES (UAAL)

Brief Recapitulation

During the 2005 regular legislative session, HB 148, requested by the PERB, and HB 181, requested by the TRB, were introduced and considered by the Legislature. The bills would have, among other things, increased the employer contribution rates for the retirement plans that had (and still have) a UAAL that exceeds amortization in 30 years or less.⁵ In spite of the bills' early and easy success, both bills were ultimately rejected by the Legislature on the premise that additional examination of options could possibly identify better options for reducing the UAAL by means more preferable than increasing the employer contribution rates.

Through the summer and fall of 2005, the SAVA examined the UAAL issue at meetings in September, October, and November (two meetings). Eventually, the SAVA requested legislation that would: (1) increase the employer contribution rates for the retirement systems having UAALs exceeding the 30-year amortization threshold; (2) close a variety of "loopholes" within the TRS; and (3)

³ See LC 2005-3, in *Minutes*, State Administration and Veterans' Affairs Interim Committee, Nov. 30, 2005.

⁴ The four "ailing" systems, i.e., systems that have an unfunded actuarially accrued unfunded liability that exceeds a 30-year duration are: the Public Employees' Retirement System; the Teachers' Retirement System; the Game Wardens' and Peace Officers' Retirement System; and the Sheriffs' Retirement System. The state's other half-dozen retirement systems are all actuarially sound.

⁵ The Public Employees' Retirement System defined benefit plan; the Teachers' Retirement System defined benefit plan; the Game Wardens' and Peace Officers' Retirement System; and the Sheriffs' Retirement System.

infuse one-time appropriations into each of the four systems.⁶ Because the scope of the requested legislation was determined to be outside the call of the special session, the legislation was not introduced in the 2005 Special Session. However, the Legislature managed to infuse one-time appropriations into each of the two largest systems, i.e., \$100 million into the TRS and \$25 into the PERS.⁷

As 2006 marches on, the UAALs in the state's public employee retirement systems march on as well, to be confronted again when the 60th Legislature convenes in 2007. Therefore, as daunting as the UAALs might be at something exceeding \$1.2 billion, there are mitigating measures that can be taken and that should eventually bring the liabilities into conformance with constitutional and statutory requirements. The most obvious and straightforward measure is to simply pay down the UAAL with a lump sum of cash. Where that cash would come from is where the difficulty arises. But there are other alternatives as well.

One Lump-Sum Payment

The state would need to infuse over \$600 million into the four unsound systems to bring each of them into actuarial soundness, i.e., reduce the term of the unfunded liability to less than 30 years. The approximate amounts necessary as one-time infusions to make the systems sound are: PERS = \$250 million; TRS = \$340 million; GWPORS = \$1+ million; and SRS = \$15+ million.⁸

The only existing single source of state money that could be tapped for these amounts is the Coal Severance Tax Trust Fund, which would require a three-fourths majority of both houses of the Legislature to accomplish. However, the state has access to capital markets through the issuance of bonds and, therefore, has the ability to essentially create enough debt-backed money to make the systems actuarially sound. This option, i.e., accessing capital markets, is discussed in greater detail later under Pension Obligation Bonds, beginning on page 9.

⁶ Op. cit. LC 2005-3.

⁷ See Ch. 1, Special Laws of 2005; a.k.a. House Bill No. 1, December 2005 Special Session.

⁸ Based on actuarial analyses performed in November 2005 and estimating the effects of appropriations to PERS (\$25 million) and TRS (\$100 million) during the Dec. 2005 Special Session, these amounts are what would have been necessary on January 1, 2006. Because of the Dec. 2005 special session appropriations and for other reasons, the amounts will change with each subsequent actuarial valuation, the next being scheduled for June 30, 2006. It must also be noted that without an increase in the contribution rate for the SRS, the Normal Cost Deficit will continue to increase the UAAL indefinitely, violating both constitutional and statutory requirements.

Periodic Lump-Sum Payments

There is an adage that says the best way for an individual to save money is to pay yourself first. That advice could be adapted to gradually pay down the UAAL through a concerted effort, i.e., legislation, requiring periodic payment towards bringing the unfunded liabilities into conformance with legal requirements. For example, the Legislature could require that a certain amount of general fund be transferred to the retirement systems on a routine basis: monthly, quarterly, annually. The "certain amount" could be a fixed amount, e.g., \$20 million, or it could be a different kind of fixed amount that would change from time to time, e.g., 10% of any amount in or expected to be in the general fund at a specific point in time that exceeds the ending fund balance established by the Legislature.⁹

By making periodic contributions to the retirement systems over and above the employer contributions required by statute, the state would gradually reduce the UAAL until the amortization periods for the systems would be under the 30-year duration generally considered prudent. Such a program would work in essentially the same way that making an extra mortgage payment works to reduce the term of the mortgage.

Employer Contribution Rates

The state's retirement systems each require contributions from the employer and the employee. Because of constitutional issues of explicit and implicit contracts and the prohibitions against the impairment of contracts, "fixing" the existing UAALs must be borne by the employers.

One of the most direct options for providing a fix is to increase the rates at which employers contribute to the unsound retirement systems. When the SAVA reviewed and recommended the adoption of LC 2005-3 in November 2005, the increases in employer contribution rates were a principal component of the proposed solution. Pursuant to LC 2005-3, the rates would have changed as illustrated in Table 1.

⁹ The Legislature may have to revise current law, e.g., 17-7-131, MCA, or enact a mechanism by which it formally sets an ending fund balance and the method by which any "excess" over the balance would be determined.

Table 1: Changes in Employer Contribution Rates Under LC 2005-3

| Retirement System | Total Employer Contribution Rate | | | |
|-------------------|----------------------------------|--------------|--------------|--------------|
| | July 1, 2005 | July 1, 2006 | July 1, 2007 | July 1, 2009 |
| PERS | 6.9% | 7.72% | 8.54% | 8.54% |
| TRS | 7.47% | 8.62% | 9.77% | 10.92% |
| SRS | 9.535% | 10.205% | 10.205% | 10.205% |

NOTE: Under LC 2005-3, there was a \$1.2 million appropriation to the GWPORS. That appropriation would have eliminated the UAAL in the GWPORS, thereby allowing the employer contribution rate to remain at its current level.

Changing the employer contribution rates remains an option to mitigate the UAAL, but it is almost certain that the rates that will be needed by July 1, 2007, will be marginally greater than the increases considered and recommended by the SAVA in 2005. At the very least the employer constrictions to the SRS will need to be increased because the current contribution rates are insufficient to even pay even the normal cost of the system's benefits; thus they don't pay anything toward reducing the UAAL in the SRS and the UAAL in the SRS continues to increase.

Participation in Public Employee Retirement Plans

Under current law, all but a very few public employees are required to participate in, i.e., become members of, the retirement system applicable to the employee's position. Nonschool public employees participate in either the general plans for public employees or in a specific plan created for specific groups of employees, such as the Judges Retirement System for judges and the Sheriffs' Retirement System for sheriffs, including deputies, jailers, et al.

Employees of elementary and secondary school districts who are typically recognized as members of the teaching profession, i.e., teachers, principals, and superintendents, are required to participate as members of the TRS. Other school employees who are typically recognized as occupying positions outside of those in the teaching profession, i.e., clerks, cooks, custodians, et al., are required to participate as members of the PERS.

Option A: Discontinue Offering Public Employee Retirement Plans to Future Employees

While the current state of affairs is broad-based, mandatory participation in public employee retirement plans, there is nothing in the state constitution that requires the state or any subdivision of the state to offer a retirement plan for public employees. Therefore, the Legislature could discontinue offering a retirement plan for all or certain groups of future employees.

By adopting such a policy, public employers would no longer be obligated to make contributions to a retirement system for the employees who are not members of a retirement system. Gradually, as existing employees who are currently members of a public retirement plan leave public employment and are replaced by new employees who are not covered by a retirement plan, employers' contributions to retirement systems would decline and eventually cease altogether.

Option B: Establish a Different Retirement Plan for Future Employees

Similar to but less drastic than completely discontinuing offering a retirement plan for public employees, the Legislature has the option of establishing a new plan for future employees that is different from the current plan for current employees. If the defined benefits of the "new" plan are leaner than the benefits of the "old" plan, it would follow that the contributions needed to actuarially fund the new plan would be less than the contributions needed to fund the old plan. Gradually, as new employees replace current employees, the relative contributions to sustain the new retirement plan would decrease compared to the contributions that would be needed to sustain the "old" plan.

Some ways in which a "new" plan could be made leaner than the existing plan include:

- increase the minimum age at which an employee may receive retirement benefits. The older a member is when first eligible to receive a retirement benefit: (1) will generally increase the duration that the contributions are able to generate investment returns; and (2) will generally reduce the number of years that the retiree will receive benefits. Either result would change the actuarial assumptions in ways that would ultimately reduce the normal cost of the plan, likely resulting in reduced rates payable by the employer.
- increase the number of years of service needed to obtain full retirement benefits or to obtain benefits under an early retirement option. A higher minimum number of years of service to reach eligibility: (1) may increase the duration that the contributions are able to generate investment returns;

and (2) may reduce the number of years that the retiree will receive benefits.

- establish a minimum combined number of years of service and age at which a member can obtain retirement benefits. For example, the Legislature could establish a plan that requires a member to meet a "Rule of 80", which means that the employee's years of service added to the employee's age must be "80" or higher for the employee to be eligible to draw a benefit. If the "Rule" is set at a higher number, e.g., 80, 85, 90: (1) there would likely be a longer duration during which the contributions are able to generate investment returns; and (2) it is likely that the number of years that the retiree will receive benefits would be reduced.
- establish a lower "multiplier" for years of service. The current multiplier for PERS members is 1.785% for each year of service,¹⁰ and for TRS members it is 1.67% for each year of service. If the presumption is that the retirement benefit should be 50% of the member's final compensation, a smaller multiplier would require the member to work more years to attain the 50% threshold, thereby: (1) increasing the number of years that contributions are made into the system; (2) increasing the duration that the contributions are able to generate investment returns; and (3) reducing the number of years that the retiree will receive benefits.
- establish a longer vesting period. The longer it takes for an employee to vest in the system the less likely it is that the employee will vest, thereby also reducing the likelihood that the employee will draw a retirement benefit from the system. If an employee does not vest and leaves service covered by the retirement system, the employee can withdraw his or her contributions to the system, but the employer's share remains as part of the system's investable assets.
- reduce or eliminate the guaranteed annual benefit adjustment (GABA). Legislation adopted in 1997¹¹ and revised in 2001¹² grants members of the PERS DB plan a 3% GABA. Similar legislation adopted in 1999¹³ grants members of the TRS a 1.5% GABA. When enacted, the enhanced retirement benefit was not paid for by direct means but instead by extending the amortization period of the UAAL of the plans. For example,

¹⁰ The multiplier increases to 2% for each year of service if the member has at least 25 years of service.

¹¹ The GABA of 1.5% for PERS participants was the result of HB 170 enacted in 1997.

¹² The GABA for PERS participants was increased to 3% in HB 294 enacted in 2001.

¹³ The GABA of 1.5% for TRS participants was the result of HB 72 enacted in 1999.

eliminating the 3% GABA for PERS would reduce the increase in the contribution rate necessary to bring the PERS into actuarial soundness by 1.35 percentage points (135 basis points).¹⁴ That translates into ~\$12.7 million annually in reduced contributions (based on an estimated \$944 million annual payroll). The reduction in contributions for the TRS would be less because the GABA for the TRS is 1.5%, only half of the PERS rate.

In addition to reducing the total contributions needed to fund the "new" plan, the Legislature could also establish different contribution rates between the employer and the employee. To illustrate, in the PERS the employer and the employee each contribute 6.9% of salary, for a combined contribution of 13.8%. If the normal cost rate under a new plan was 13.8%, the Legislature could establish different contribution rates for the employer/employee split, ranging from 0% for the employer and 13.8% for the employee to 13.8% for the employer and 0% for the employee--or anything in between. The rates could be set at virtually any level considered appropriate by the Legislature.

Thus, by establishing a leaner, new retirement plan for future employees, the Legislature could reduce, in relative terms, the amount of employer contributions needed to sustain the plan. The employer share of the total contributions necessary to sustain the plan could also be reduced, further reducing the cost to the employer.

Option C: Require All New Employees to Participate in a Defined Contribution Plan

The state has the option to require all new employees, first hired after a future date certain, to participate in an alternative plan to the existing defined benefit (DB) plans. Thus, the state could require all new employees to participate in, for example, the defined contribution (DC) plan that is currently available to PERS members rather than the DB plan that is the default for new PERS members. By adopting the DC-plan-only option, the employer's liability is finite and not subject to the vagaries and vacillations of returns on invested assets that weigh on the solvency of an employer-sponsored DB plan.

Under a DC plan, the employer has the ability to adjust employer contributions as necessary or advisable and could, theoretically at least,

¹⁴ Letter to Roxanne Minnehan, Interim Executive Director, MPERA, from Mark O. Johnson, Milliman Associates, January 12, 2006.

decrease contribution rates during challenging budget times or increase contributions whenever experiencing flush budgets.

A minor suboption to this alternative is to *allow* rather than *require* employees to participate, which would likely further reduce the employer's obligation.

Pension Obligation Bonds

Pension Obligation Bonds (POB) are essentially general obligation bonds, the proceeds of which are used to buy down the UAAL of the public retirement system. POBs are backed by the full faith and credit of the governmental entity that issues the bonds, which means they are repayable from revenue over which the issuing authority has power and control--in the simplest terms, tax revenue.

In an article written by the consulting firm of Gabriel, Roeder, Smith & Company, the authors characterize POBs in this way:

POBs are financing instruments intended to relieve the issuer of some of the annual pension contribution. POB proceeds are typically used to pay some or all of the pension plan's unfunded accrued liability (UAL) and may also include funds to pay the plan's normal costs for two or three years into the future.

In order to achieve the expected budgetary relief, the issuer hopes to invest the bond proceeds at a rate higher than the total cost of borrowing. The desired result is that the transaction reduces the annual pension contribution required to fund the plan by more than the total cost of borrowing.¹⁵

In some ways, POBs are similar to a mortgage: the borrower agrees to borrow a fixed amount of money for a fixed period of time and agrees to pay the lender a premium, i.e., interest, for the time-value of the money loaned and the risk incurred by the lender by loaning the money. At intervals specified in the POB prospectus, the borrower pays the lender an amount based on the bond's interest rate and the outstanding principal of the bond. At the end of the loan period for which the POB was issued, the principal will have been fully paid back to the lender--along with the interest that will have been paid with each payment made by the borrower.

POBs are not as attractive financially today as they were 20 years ago, nor are they without risks. According to the Gabriel, Roeder, Smith & Company article referenced previously,

¹⁵ "Questions to Consider Before Issuing Pension Obligation Bonds", *GRS Insight*, Vo. 2004, No. 1, February 2004.

POBs were originally tax-exempt borrowings. But today, due to certain provisions of the Tax Reform Act of 1986, they must be issued at taxable rates. Therefore, governments usually issue POBs at higher interest rates than they would pay for tax-exempt borrowing, making it more difficult to produce the desired result.

Some borrowers reason that issuing a POB is similar to refinancing a debt that bears a high interest rate (the pension plan's UAL) with one that bears a lower interest rate (the POB).

However, the long-term, actual investment performance of the retirement plan is what determines the final savings or cost of issuing the POB...¹⁶

The widely-recognized Standard and Poor's Company has a keen interest in the financial health and capacity of public entities, and periodically issues "ratings" on a state's financial condition. Other companies, such as Fitch and Moody's issue similar ratings. In particular, Standard and Poor's (S&P) has also weighed in on the subject of POBs and the following quote is taken from an S&P analyst report written a couple of years ago.¹⁷

While the financial implications of POBs are complex, the actual mechanics are relatively simple. Generally, the municipal employer will use the findings from the most recent actuarial valuation, or have a new valuation completed, to determine the pension system's unfunded actuarial accrued liability (UAAL). Then, it will decide what portion of the UAAL (either all or a part) will be funded with the POB. In the 1990s most employers funded the entire UAAL, but for various reasons discussed below, many now tend to finance less than the full amount. Once the POB is sized and sold, the net proceeds are placed in the pension trust fund to be commingled with the other funds, and usually invested according to the existing asset allocation guidelines... Thus, the pension fund experiences a rapid increase in assets resulting in a higher funded ratio (actuarial value of assets divided by actuarial accrued liability). For the POB to generate savings for the employer, the investment return rate on the POB proceeds must be greater than the interest cost of the bonds (and ideally equal to, or exceed the pension system's investment return assumption), and the larger the spread between these two rates the better. The employer, as POB issuer and obligor, would then be projected to achieve lower total pension contribution and debt service costs than it would have if it had not sold the POB.

But the S&P analysts who authored the article continue by delineating some of the risks of issuing POBs, some of which are not immediately obvious. The

¹⁶ Ibid.

¹⁷ "Pension Obligation Bonds Are Surging After Brief Hiatus", by Parry Young and Steven Murphy, Credit Analysts, Standard and Poor's Company, New York, NY, January 20, 2004.

following, more-lengthy quote from the same article explains some but not all of the risks.

POBs are essentially an arbitrage play, the success of which is dependent on the premise that the pension fund assets (including POB proceeds) will earn on average more than the interest cost on the POBs and hopefully the assumed investment return rate (generally about 8%) or better each year for the life of the bonds. If the bonds are sold at an interest cost of 6%, for example, the spread could generate handsome savings if the investment returns goals are met over the life of the bonds. The problem is that there is no certainty that the average 8% return will be realized over time, and therein lies the principal risk of the POB to the issuer. If the pension fund earns 8% or more on the POB proceeds, then the result will be success by virtue of having to pay lower pension-related costs (contributions plus POB interest) than without the POB. However, if the investment return is less than the POB interest cost, the transaction becomes a drag on cash flows. Not only will the employer have the new POB debt service costs but also higher contribution rates attributable to new unfunded liabilities from under performing investment returns. If returns are above 6% (as in the example above) but below 8%, the employer will have increasing contribution rate costs, but it would have had them even without the POB. When investment returns are less than the POB interest costs, the POB puts additional strains on financial operations rather than helping.

Taking at face value the fact that there are risks associated with issuing POBs, many states and other entities have issued them and have successfully arbitrated the proceeds. The Committee or the Legislature should investigate fully and exercise due diligence if either wishes to pursue the POB option.¹⁸

PART II: OTHER ISSUES RELEVANT TO PUBLIC RETIREMENT SYSTEMS

The PERS Defined Contribution (DC) Plan

In 1999, the 56th Legislature enacted House Bill No. 79 (Ch. 471, L. 1999) establishing a defined contribution retirement plan within the public employees'

¹⁸ Other relevant papers on the subject of Pension Obligation Bonds include: "Managing State Pension Liabilities: A Growing Credit Concerns", Parry Young, Standard & Poor's, Jan. 20, 2005; "Reversal of Fortune: The Rising Cost of Public Sector Pension and Other Post-Employment Benefits, Joseph D. Mason, Fitch Ratings; September 18, 2003; "Questions to Consider Before Issuing Pension Obligation Bonds" in GRS Insight, Feb. 2004, Vol. 2004, No. 1; "Credit FAQ: Public Pension Funds", Parry Young, Standard & Poor's, Nov. 17, 2003; "Risky Business? Evaluating the Use of Pension Obligation Bonds"; James B. Burnham, in *Government Finance Review*, June 2003.

retirement system as an option available to PERS-covered employees. The legislation anticipated gradual implementation of the DC plan option and allowed approximately 2 years for the MPERA to establish the specifics of the plan, educate PERS members, contract with a plan administrator, etc. Employees covered by the PERS defined benefit plan prior to July 1, 2002, were given a one-time option to elect to either continue participating in the DB plan or convert to the DC plan.

Between the time the law was adopted in 1999 and its implementation date in July 2002 the country witnessed several events gave pause to PERS members who were contemplating the relative advantages and disadvantages of the DB and DC plans. Among the events were the bursting of the "tech bubble" in the equity markets and the initial ripple effects of the bursted bubble (including the Enron and Worldcom debacles) and the consequences to the markets of the events of September 11, 2001. Suffice it to say that the impetus that was behind the development and adoption of the DC plan in 1999 had not only disappeared prior to July 1, 2002, the momentum had shifted virtually 180 degrees in the opposite direction.

Now, 7 years hence, may be an appropriate time for the SAVA to examine the DC plan more closely. The examination could include identifying and studying the demographics of DC plan participants in an effort to determine the current and future viability of the DC plan. The Committee could also identify and assess the effects, if any, to the PERS DB plan caused by PERS members electing the DC plan alternative, including search for any unanticipated consequences of the DC plan.

Comparing Montana's Public Employee Retirement Plans and Retirement Plans in the Private Sector

Seven hundred sixty dollars per month. That is the average monthly retirement benefit paid to PERS retirees.¹⁹

How that amount stacks up to retirement benefits paid to retirees from employment in the private sector is a question that the SAVA members may wish to investigate. Assuming that large employers in the private sector would provide comprehensive data to analyze for comparison, the answer to the \$760 question could go a long way to respond to the editorialists, pundits, and others who opine that a retirement benefit of \$760 a month is either too low or too

¹⁹ *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2004*, Montana Public Employees' Retirement Board, November 24, 2004.

high.²⁰

If the Committee chooses to conduct the comparisons, it is likely that it will have to put its entire weight and standing behind requests for information to appropriate private sector employers because that type of information, particularly in disaggregated and detailed form, may be difficult to obtain.

Comparisons Between Montana's Public Employee Retirement Plans and Retirement Plans in Selected States

In parallel to an interest in how Montana's public retirement plan benefits compare to private sector retirement benefits is an interest in how Montana's public employee plans and benefits compare to plans and benefits offered by other states' retirement systems. The information needed to make detailed comparisons is readily available for most states and can be obtained if the Committee chooses to go in this direction.

If the Committee wants comparisons made and analysis done, the members should clearly state what the goals and objectives of the research are to ensure that staff gather useful information and analyze the information in ways that produce findings and conclusions that add value to the discussion. Developing comparisons of all 50 states may be useful as an academic exercise, but the SAVA members should decide if other comparisons would be more useful for the members' stated purposes.

Retirement Benefits as a Component of Recruitment and Retention Strategies

Some stakeholders maintain that retirement benefits are a principal component of consideration to potential employees being recruited and to current employees who employers are attempting to retain. Others may not be so sure. Regardless, retirement plans play some role in the recruitment and retention strategies of states as employers.

Examining the state of the art strategies for recruiting and retaining qualified employees for public service and comparing those strategies to the current state of affairs in Montana public service could give the Committee insights into just how competitive Montana's strategies and policies are. Hard data may be hard to find, but there are numerous resources available to provide qualitative comparisons.

²⁰ The Employee Benefits Research Institute reports that the mean "average" monthly retirement benefit for private sector retirees in 2004 was \$974. See "Mean Annual Income from Retirement Annuity and/or Employment-based Pension" in *EBRI Databook on Employee Benefits*, 4th ed., (March 2005), Table 8.5.

As with possible comparisons discussed previously, the SAVA members should clearly state the goals and objectives of the research and analysis to ensure that staff provide useful information as a result.

A Closer Look at the Investment of Montana Public Retirement Systems' Assets

The preamble and substance of HJR 42 suggest that the 59th Legislature was keenly interested in the performance of public pension assets and, perhaps, in the performance of the Board of Investments and its staff and consultants as well, to wit:

WHEREAS, a significant decline in the market value of public retirement plan investments from fiscal year 2000 through fiscal year 2003 resulted in actuarial losses to the public retirement plans totaling more than \$1.3 billion...

WHEREAS, between 58% and 75% of the funding for the public employee retirement plans comes from investment earnings, while only 12% to 20% of the funding comes from employer contributions;...

WHEREAS, public retirement plan funds are invested by the state Board of Investments and constitute nearly \$6 billion or 62% of all investments managed by the Board of Investments....

The resolution continues with directions to the study committee:

...(2) study the investment strategies, objectives, and asset allocation of public employee retirement funds managed by the Board of Investments;

(3) compare the asset allocation, investment performance, and actuarial assumptions regarding Montana's public employee retirement plan funds with asset allocation, investment performance, and actuarial assumptions used in other states;

(4) study how investments or asset allocation strategies are adjusted by the Board of Investments either in anticipation of changing needs or changing market conditions or after significant national and world events affect the market;

(5) study actual rates of return versus actuarial gains and losses in market value and how actuarially assumed rates of return adopted by the retirement boards relate to realized returns and the investment objectives set by the Board of Investments....

The focus of the Legislature's interest has not been lost on the Board of Investments (BOI) or its staff. For example, in a recent memorandum from the Board's executive director, the topic was addressed in this manner:

...when pension fund portfolios generated annual returns ranging from 12 to 20 percent (well above the 8 percent actuary assumptions), the Board's investment performance attracted little attention. Instead, credit was given to the stock market itself and the Legislature increased pension benefits based on what was then described as stock market "gains." However, the focus changed dramatically when the market began its precipitous fall in September 2000. Rather than attributing investment losses to declining markets, the blame shifted to the Board and its investment decisions and performance.... Since the enactment of this resolution, Board staff have prepared three written reports to the Legislature and testified several times before interim legislative committees. While the focus on pension system unfunded liabilities has broadened somewhat since the session and now includes the impact that legislatively-granted benefit increases have had on pension liabilities, the focus on the Board's investment performance will intensify going forward....²¹

If the language contained in HJR 42 is indicative, legislators were concerned about the investment performance of retirement plan assets, basically: What happened, how did it happen, and who is accountable? To the extent that legislators continue to have a keen interest in the performance of public pension plan assets, the Committee may wish to examine "performance" in any number of ways. For example, would it be useful to prepare more detailed comparisons of the performance of other public retirement systems' pension assets or with the performance of the pension assets of retirement systems in the private sector? Similarly, would it be useful to compare the performance of other public entities that have responsibility for investing pension system assets?²² How about performance of private entities that have responsibility for investing private pension system assets?

Once the basic questions are answered--what, how, who, etc.--the Committee may wish to consider whether existing public policy is appropriate. For example, is the structural relationship between the retirement boards and their staffs and the BOI and its staff appropriate. Is it sound policy to have a distinct board to represent the retirement interests of nonschool public employees, another board to represent school-related public employees, and a third board to manage the investment of the retirement systems' pension assets? Would the state be better served by having a single board to be more comprehensively accountable for the administration of public retirement systems *and* for the investment of assets held for the benefit of those systems?

²¹ Memorandum to Board [of Investments] Members from Carroll South, Executive Director, Montana Board of Investments, February 17, 2006.

²² The BOI staff has begun to examine this topic. See, *op cit.*, Carroll South, Executive Director, Montana Board of Investments, February 17, 2006.

Early Retirement Options

On February 18, 2006, eight coworkers at a meat packing plant in Nebraska split a record \$365 million Powerball lottery jackpot. During an interview on February 22, one of the winners, when asked if he was going back to the meat packing plant, said, "No. I retired 4 days ago."

Not everyone has the same option to retire early that the quotable Nebraska meat packer had, but "early retirement" as a public policy is something that emerges for consideration from time to time. There are at least a couple of different forms of "early retirement", but they differ in important ways.

Early Retirement Per Se

The most common form of early retirement allows employees who are not otherwise eligible for "full" or "regular" retirement to take an early retirement with a reduced benefit without meeting the thresholds they would have to meet to obtain full retirement benefits. As used here, "full" and "regular" retirement benefits means that the retiree's benefits are not reduced according to a formula employed to determine what are typically reduced benefits for early retirement.

Under the PERS DB plan, an employee obtains full retirement benefits in one of three ways: (1) by accruing 30 years of service, regardless of age; (2) by reaching age 60 and having 5 years of service; or (3) by reaching age 65, regardless of years of service. The benefit for a PERS DB employee who is eligible for regular retirement is determined by multiplying the employee's years of service times a retirement factor²³ and then multiplying the product by the employee's final average compensation.

A member of the PERS DB plan is eligible for "early retirement" when the person reaches age 50, but the benefit amount is reduced to reflect the actuarial effects of the early retirement. The amount of the reduction depends on the employee's age at retirement, but in general terms, the benefit is reduced (from the full/regular benefit) by 6% for each year under age 60 that the employee is upon his or her retirement date. The basic formula for calculating the retirement benefit is the same for early retirement as it is for full retirement, *except* that the "regular" benefit is discounted by 6% for each year the employee is under age 60.

²³ The "factor" is 1.785% if the employee has accumulated service of less than 25 years or 2% if service is 25 years or more; 19-3-904, MCA.

To illustrate, an employee who is at least 60 years old at retirement who has 20 years of service will receive 36% of his or her final average compensation: 20 years of service times 1.785% times final average compensation. In contrast, an employee who is only 50 years old at retirement and who also has 20 years of service will receive only 21% of his or her final average compensation: 20 years of service times 1.785% times final average compensation times the product of 60 minus the employee's age at retirement times 6%.

Even though the early retirement option available under the PERS DB plan is actuarially sound, eliminating it could eventually enhance the actuarial soundness of the PERS DB plan because plan assets that would otherwise be withdrawn to pay benefits to early retirees would instead remain available for investment until the employee would become eligible for full/regular retirement, and the earnings on those investments would accrue to the benefit of the plan but not expressly to the benefit of the employee member.

Early Retirement Incentives

The concept that underpins offering an incentive to employees to retire early is basically that any employee who retires either will not be replaced at all or will be replaced by an employee who earns less than the retiring employee. In either case, the employer's cost is reduced. Public and, more frequently, private entities periodically offer incentives to employees to promote early retirement.

The incentives that are typically offered range from inflating "final average compensation" to adding years to an employee's term of service (even though the employee didn't work the years added) to increasing the multiplier by which years of service and final average compensation are multiplied to an employer paying the retiree's health insurance premiums for a certain period of time (5 or 10 years) or until the retiree becomes Medicare eligible--or combinations of the above.

To the extent the theory does work and a retiring employee is either not replaced or is replaced by an employee at a lower salary, the employer's costs, including costs of contributing to a retirement plan, would appear to decline. But there are other factors, especially changes in employee productivity, that are not easily measured and that may overstate the degree to which the employer's costs are ultimately reduced.

These types of early retirement incentives are what are commonly reported in relation to corporate downsizings or restructurings and, less frequently, reported in conjunction with government retrenchments.

Specific Components of the State's Existing Plans

At the September 9, 2006, SAVA meeting, staff presented background information on selected state retirement systems, including Montana's PERS and TRS DB plans.²⁴ The Committee may have an interest in investigating further the specifics of each of the plans, including the nine DB plans or two DC plans. Staff can provide as much detail on the provisions of the plans as the members desire to have.

Development and Adoption of Actuarial Assumptions

The language in HJR 42 alludes to "actuarial assumptions regarding Montana's public employee retirement plan funds" and suggests that the committee discover and examine what the assumptions are and how they are developed and adopted.

To be sure, many of the actuarial assumptions are based on data empirically derived from mortality tables, surveys of current employees, and historical data points. While the prospectus for any mutual fund typically says something like "past performance is no guarantee of future results"--which is probably true--such a warning is at least partially offset by more seasoned platitudes, such as "those who do not learn from history are condemned to repeat it"²⁵ --which is probably also true.

Nevertheless, developing and adopting the actuarial assumptions used to determine the actuarial health and cash flow needs of a retirement system may be as much of an art as it a science. For example, when developing actuarial assumptions, there is perhaps no finer art than predicting what will be the rate of return on assets invested over the next 30 years or so.

Therefore, the Committee may wish to examine the actuarial assumptions adopted by the PERB and TRB and discover how each of the Boards determines the assumptions given to the actuary to plug in to the various algorithms relied upon to determine everything from the normal costs and the unfunded accrued actuarial liabilities of the systems to the underlying, long-term solvency of the systems.

²⁴ Background Information on Selected State Retirement Systems, David D. Bohyer, September 9, 2005, in *Minutes*, State Administration and Veterans' Affairs Interim Committee, September 9, 2005, Montana Legislative Services Division files.

²⁵ Attributed to the Mexican philosopher Santayana.

The PERS and TRS Investment Portfolios

Separate from or perhaps in addition to the discussion presented above under the heading "A Closer Look at the Investment of Montana Public Retirement Systems' Assets", the Committee may be interested in a periodic briefing on the portfolios of assets invested by the BOI on behalf of the PERS DB plans and the TRS DB plan. It could be that, as the advertisement of yore intimated, "Inquiring minds want to know".

SUMMARY AND CONCLUSION

Clearly, the UAALs in several of the state's retirement plans are high-profile, front-burner issues for the time being, and it appears to be a legislative priority for the SAVA members and others to both understand the UAALs as completely as possible and forge a plan to mitigate the liability. Nevertheless, there are other subjects that may also warrant attention in their own right, either as factors affecting the UAALs or as retirement-related public policy issues that go beyond pension liabilities. If the thrust of HJR 42 is indicative of the Legislature's interest in public employee retirement issues, then the SAVA has a veritable smorgasbord of retirement-system-related topics they may wish to investigate further.

HJR 42\03066a -- Report to SAVA on PER Issues.wpd
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