



State Administration and Veterans' Affairs Interim Committee
62nd Montana Legislature

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TO: Members of the State Administration and Veterans' Affairs Committee

FROM: Megan Moore, Legislative Services

RE: Statutory Duties Related to the State's Public Employee Retirement Systems

DATE: October 7, 2011

This memo provides background on the State Administration and Veterans' Affairs Interim Committee's interrelated duties to establish principles of sound fiscal and public policy and to solicit and review proposed statutory changes to any of the state's public employee retirement systems. Included is a summary of Committee duties and options, past hurdles in fulfilling these responsibilities, and possible steps to aid in completion of the tasks.

Principles and Guidelines for Public Employee Retirement Systems

Section 5-5-228(2)(b) requires SAVA to "establish principles of sound fiscal and public policy as guidelines." These principles and guidelines are to be used as benchmarks 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.¹

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 the same as those adopted by the 2007-2008 SAVA Committee:

PRINCIPLES

- 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

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.

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?

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 (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 24 guidelines adopted by previous SAVA Committees 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.

Action: The Committee should consider whether to adopt the same principles and guidelines as the 2009-2010 SAVA Committee or whether to revise any of the principles and guidelines. The Committee may wish to review principles and guidelines used by other states.

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."

Review of Proposed Statutory Changes to Public Employee Retirement Systems

SAVA's duty to review proposed statutory changes to the state's public employee retirement systems is outlined in section 5-5-228(2)(d) through (2)(f). The duties include:

- solicitation and review of any proposed statutory changes to any of the state's public employee retirement systems;
- providing a report to the Legislature on each legislative proposal reviewed by the Committee. The report is to include a summary of the fiscal implications of the proposal, an analysis of the effect that the proposal may have on other public employee retirement systems, an analysis of the soundness of the proposal as a matter of public policy, any amendments proposed by the Committee, and the Committee's recommendation on whether the proposal should be enacted by the Legislature.
- attaching the Committee's report to any proposal that the Committee considered and that is or has been introduced as a bill during the legislative session.

Past SAVA Committees have fulfilled these requirements to varying degrees. Previous SAVA staff identified three main difficulties in the proposal review process: hesitation in making recommendations, timing and format, and gathering fiscal information.

The first difficulty, a hesitation to make recommendations on proposed statutory changes to public employee retirement systems, may stem from the fact that SAVA is the only interim committee charged with reviewing and making recommendations about proposed statutory changes. Every interim committee has the ability to review and request legislation for agencies for which the committee has oversight but SAVA's review of proposed changes to public employee retirement systems is broader. The Committee is not only to review proposals, but also to provide a report including recommendations and an analysis of the proposals. The proposal review responsibility also extends beyond state agencies to any stakeholder organization or individual with a proposed statutory change to the retirement system. Because this duty is required in statute, the only way for SAVA to change or remove this responsibility is to amend the statute.

The second issue that SAVA Committees have faced as they attempt to review statutory changes to the retirement system is that the proposals are not complete in time for the Committee to make an informed decision. A related difficulty is that the proposed changes are often not in bill format and/or are not very specific, making it difficult for Committee members to decide whether or not to recommend the proposal. These problems are connected: SAVA needs the proposals during its spring meetings in order to give staff time to draft a final report for Committee review at the final meeting, but agencies and stakeholders wishing to submit proposed changes may not have their proposals ready within SAVA's timeframe. The guidelines for interim committees require that committee work be done by September 15. Potential fixes for these problems are to request that staff draft proposals as sample bill drafts, even if bill drafts have not been officially requested and assigned an LC number, and/or to ask the Legislative Council to allow SAVA to meet after the September 15 interim guideline end date.

The final difficulty faced by SAVA is the gathering of timely fiscal impact information. Legislators serving on SAVA often wish to review fiscal information about retirement system proposals before casting any votes as to whether to recommend the legislation. In the past, SAVA staff has gathered data from recent fiscal notes and consulted with the Office of Budget and Program Planning, the Public Employees' Retirement System, and the Teachers' Retirement System to provide rough cost estimates. However, in order to provide this fiscal information, staff needs a specific proposal and, preferably, a bill draft, which can be problematic as discussed above. If the Committee wants actuarial data, there are further complications of timing and cost. The actuarial valuations of the state retirement systems are available in the fall after the September 15 guideline end date for interim committees. The cost of actuarial services is also not included in SAVA's budget. SAVA could request an appropriation for actuarial services, though last interim SAVA had an appropriation as part of the Committee's House Bill No. 659 study but was cautious in requesting actuarial valuations of proposals and ultimately did not spend the entire appropriation. An actuarial valuation would also require a bill draft.

Action: The Committee should consider how to fulfill the statutory duty to review and make recommendations about retirement system proposals, including in what format the Committee wants to review the proposals and what fiscal information is desired. The Committee may wish to have staff draft unofficial bill drafts of stakeholder and agency proposals for Committee review, request from Legislative Council an exception from the September 15 guideline date for completing interim work, and/or consider changes to the statute that requires review of retirement system proposals.

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