Part II

Pension Funding

Recap last meeting

- Tightening financial analysis: more like private
  - GASB
  - Fitch
  - Moody's
- Allocation of liabilities
  - State (including MUS)
  - Local cities and counties
  - Schools

Summary of Changes in Actuarial Funding Status

- Increased UAAL by $600 million from $3.3 billion to $3.9 billion

- ARC gap less than was anticipated last year
  - Higher than anticipated market return
  - Legislative changes reduced liability
  - Salaries were less causing less contributions and fewer long term liabilities
  - Other demographic changes

Still large estimated ARC gap

TRS

- If closed in FY 2012 would be 3.5%
- The gap is anticipated to be 4.63% in the 2015 biennium

PERS

- If closed the gap in FY 2012 would be 6.70%
- The gap is anticipated to be 5.45% in the 2015 biennium

Stated in terms of employer contribution rate increases for comparison purposes. Other options could also reduce the gap.

Comparison

MONTANA

- The $3.9 billion UAAL is just under half of the annual unduplicated spending in state, schools, and local government budgets
- Assets in the Montana systems total $7.6 billion
- Total liabilities are $11.4 billion

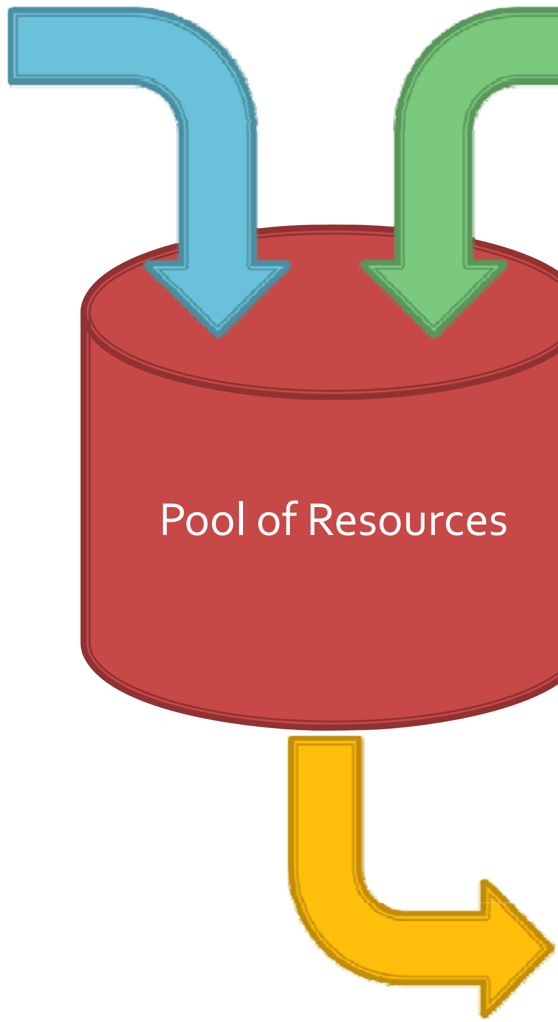
PITTSBURGH – RECENTLY IN THE STATE LINE NEWS

- "But by 1996, the unfunded pension liability swelled to $519 million, with only $118 million in assets. By contrast, the entire city budget was $322 million." http://www.stateline.org/live/details/story?contentId=607854

Concept: Benefits > Earnings

Contributions: Current Employee Wages determine Contributions and Future Benefits. As employees make more money, more funds will be needed in the pool to pay benefits in the future.

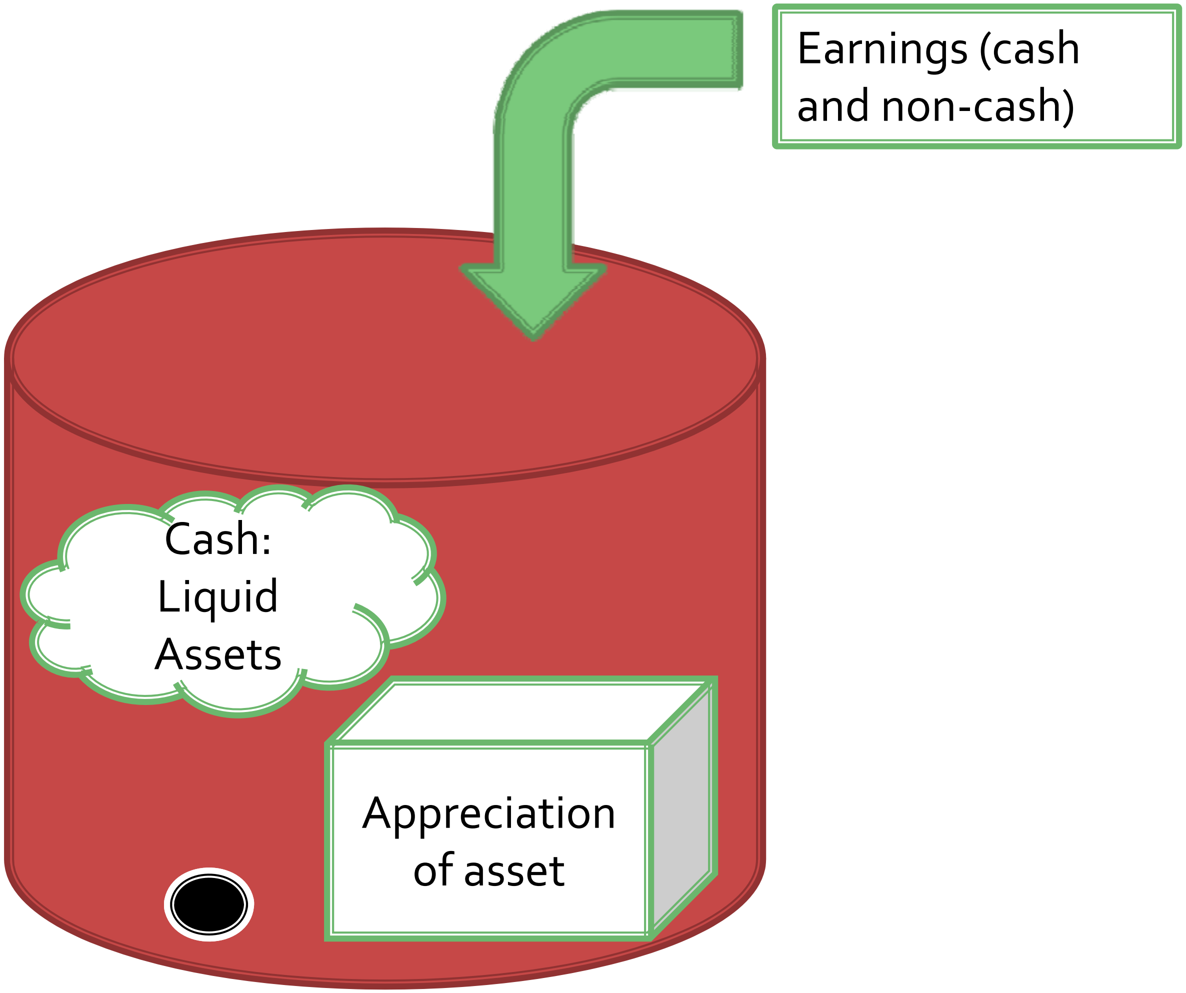
Investment Earnings (cash and non-cash)



Benefits to former employees based on former wages

Concept: ROI Cash and Non-cash

ROI includes: Appreciation of Assets and Cash (dividends or bond payments)



Return on Investment

Carroll South, Board of Investments

Risks: Return on Investment

Future Growth Potential

Experts

- Even with Current Asset Allocation ROI may not reach the annual assumed 7.75% ROI
  - Pew
  - Fitch
  - Center for Retirement Research at Boston College
    - How Would GASB Proposals Affect State and Local Pension Reporting?
  - IHS Global Insight

Pew: The Widening Gap: The Great Recession's Impact on State Pension & Retiree Health Care Costs, Page 8

"Therefore, some experts recommend that states employ a **"riskless rate"** that might be analogous to a 30-year Treasury bond when valuing their future pension liabilities, arguing that pension obligations are legally binding and guaranteed to recipients.[9] Based on the Treasury bond's rate of 4.38 percent as of mid-March 2011, the states' cumulative liability for pension benefits would grow to $4.6 trillion, with an unfunded liability of $2.4 trillion.[10]"

Pew: The Widening Gap: The Great Recession's Impact on State Pension & Retiree Health Care Costs, Page 8

"Another benchmark suggested by some experts is the investment return required by the Financial Accounting Standards Board (FASB), a private counterpart to the Government Accounting Standards Board.[11] **FASB** requires that private sector defined benefit plans use investment return assumptions based on the rate on corporate bonds: 5.22 percent as of mid-March 2011.[12] Based on this assumption, states' pension benefit liabilities would grow to 4.1 trillion, $1.8 trillion of which would be unfunded."

Fitch: Enhancing the Analysis of U.S. State and Local Government Pension Obligations, Page 6

"Each system's UAAL will be adjusted to approximate the impact of a 6%, 7%, and 8% investment return assumption to provide a range of outcomes. **Fitch believes** that, given the recent market downturn and potential for lower returns in the future, the current 8% average discount rate used by public pension plans is likely optimistic."

Center for Retirement Research at Boston College

"Most economists contend that the discount rate should reflect the **risk associated with the liabilities** and, given that benefits are guaranteed under most state laws, the appropriate discount factor is closer to the riskless rate. The point is not that liabilities should be larger or smaller, but rather that the discount rate should reflect the nature of the liabilities; the characteristics of the assets backing the liabilities are irrelevant."

IHS Global Insight

- Last 30 years compounded yield an average ROI:
  - S & P 500: about 8%
  - Aaa corporate bonds: about 8%
- Last 20 years and looking forward the next 10 years give compounded yield of
  - S & P 500: just below 6%
  - Aaa corporate bonds: just above 6%

Risks: Other

Shifting Liabilities
Salary growth
Retirement rate
Other demographic shifts

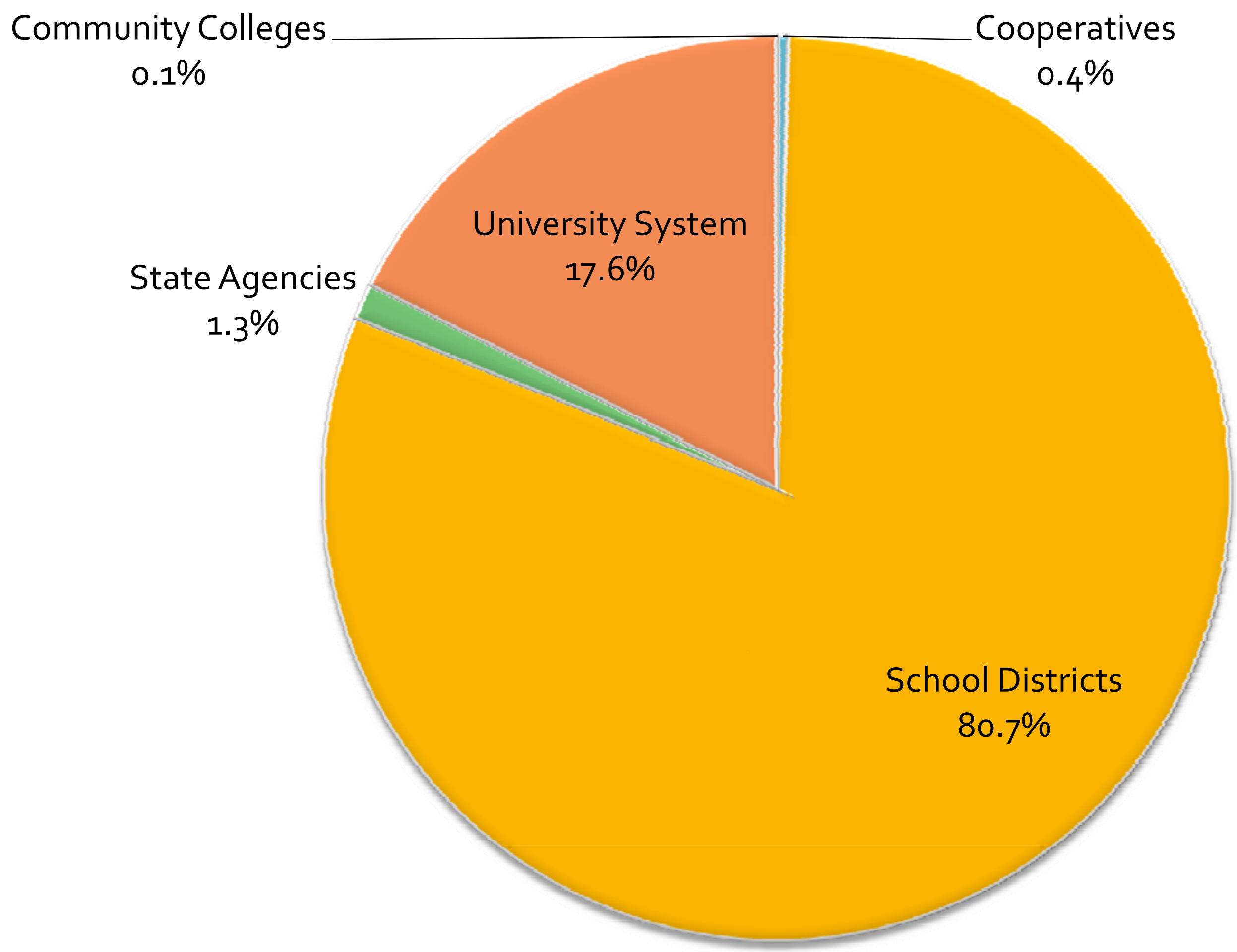
Getting a Bigger Slice of the Pie

- City of Billings example:
  - City now considers health benefits as salary and pays PERS employer and employee share of these costs and they will be used to calculate the highest 3 years salary
  - City of Billings created additional liability to participating employers as the benefits will now be higher

TRS only: Option 1

- Actuarially paid additional benefits
- Liabilities are generated from Option 1 if ROI averages lower than 7.75%
- Shifts the liability to all TRS participants if ROI is lower than 7.75%

TRS: FY 2011 Termination Pay Total=$7.46 million



Other Risks

Other risks, with positive and negative impacts will influence the future liabilities.

- Salary growth
- Retirement rate
- Other demographic shifts

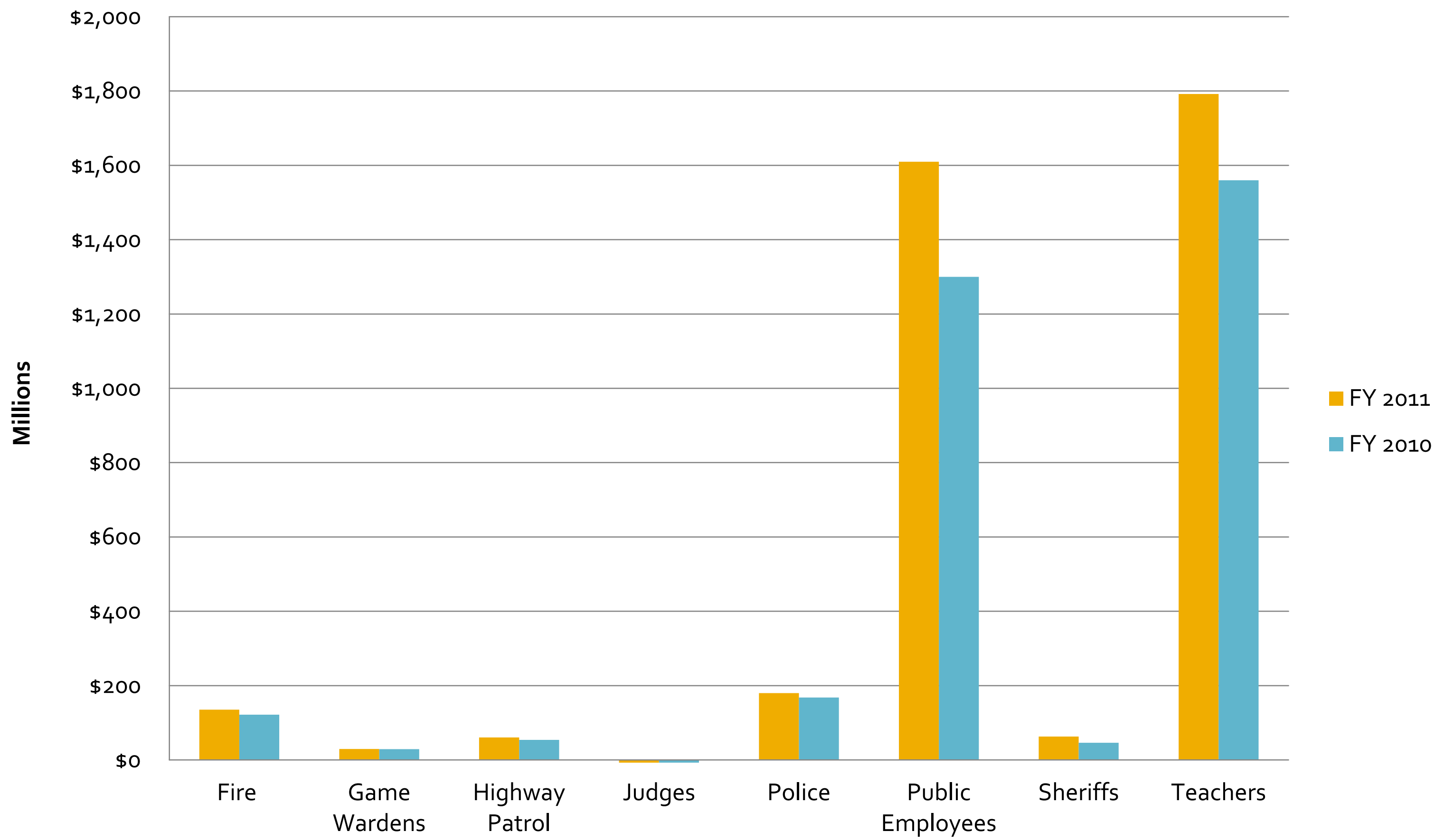
Summary

- UAAL grew from $3.3 billion to $3.9 billion or 18%, which is less than anticipated in the FY 2010 Actuarial Analysis
- The UAAL is 50% of total annual spending
- Annual state and local spending is about $8 billion
- The shortfall in ARC is about 1.5% of the annual spending

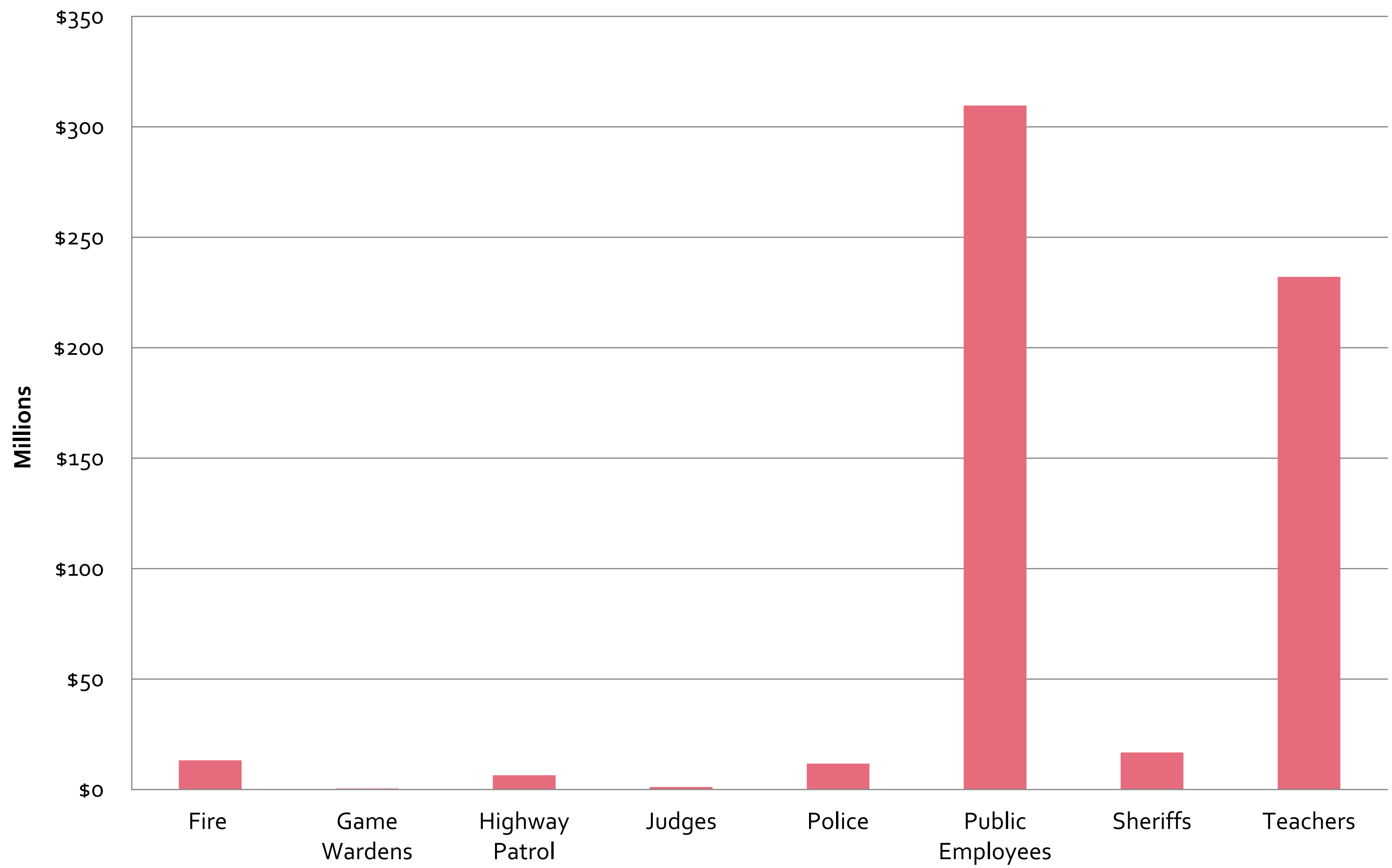
Funding Status Update

Stephanie Morrison, PhD; Fiscal Analyst; Legislative Fiscal Division

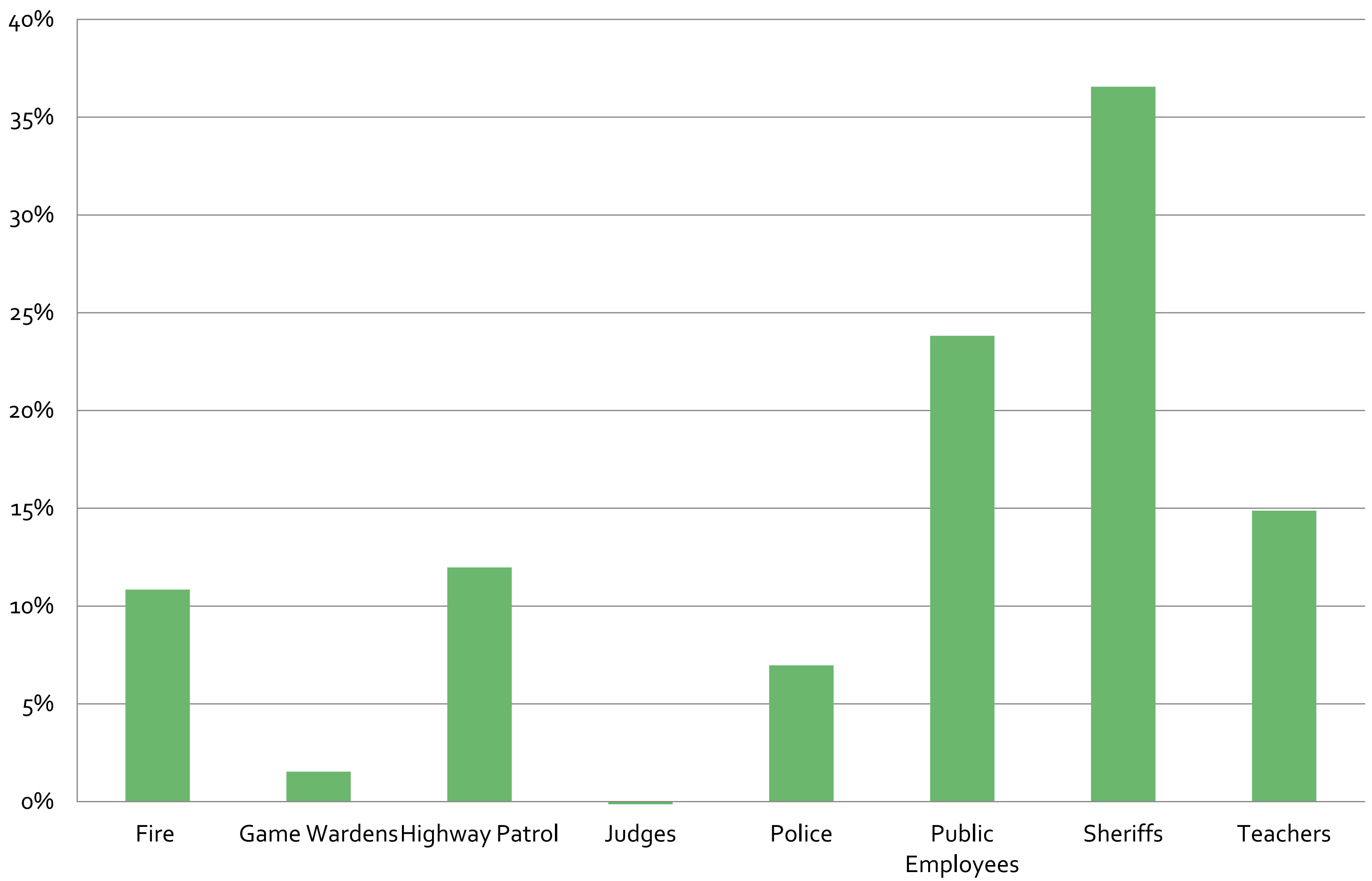
Changes in Unfunded Liability



Total UAAL Increased $591.6 Million

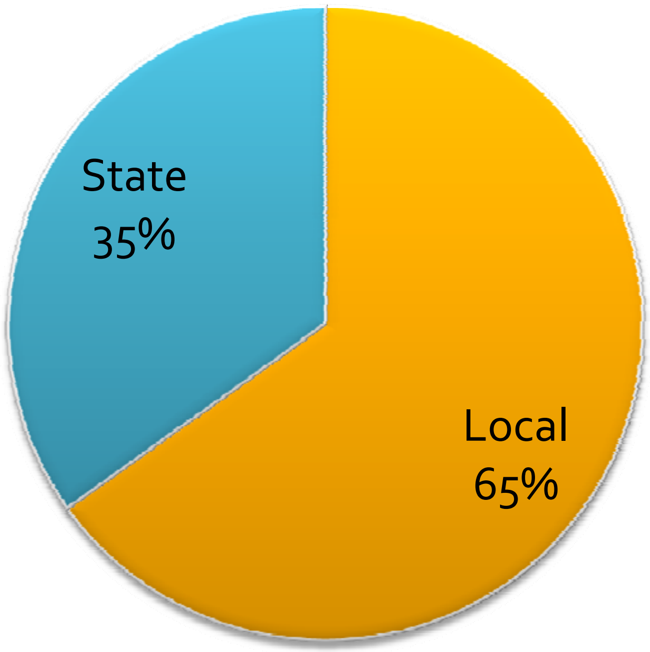


Total UAAL Increased 18.1%

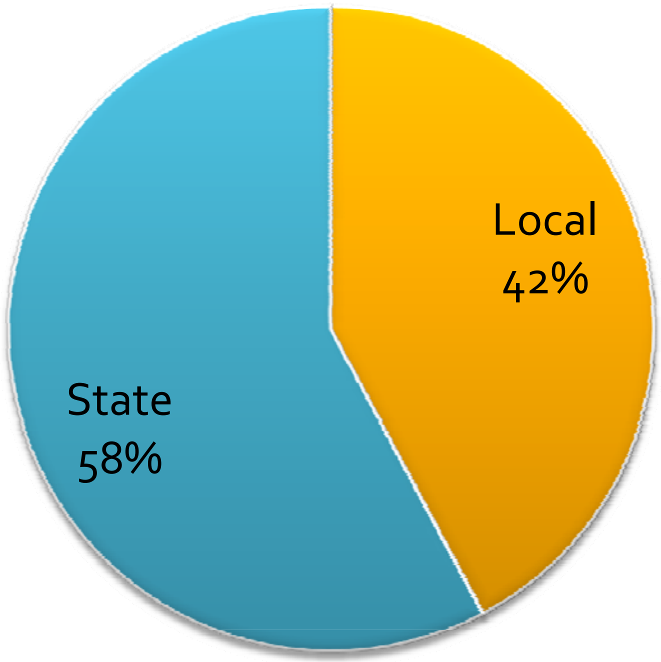


FY 2011 Wages & Retirement Contributions

WAGES



CONTRIBUTIONS



Comparison Using Employer Contribution Rate Increases

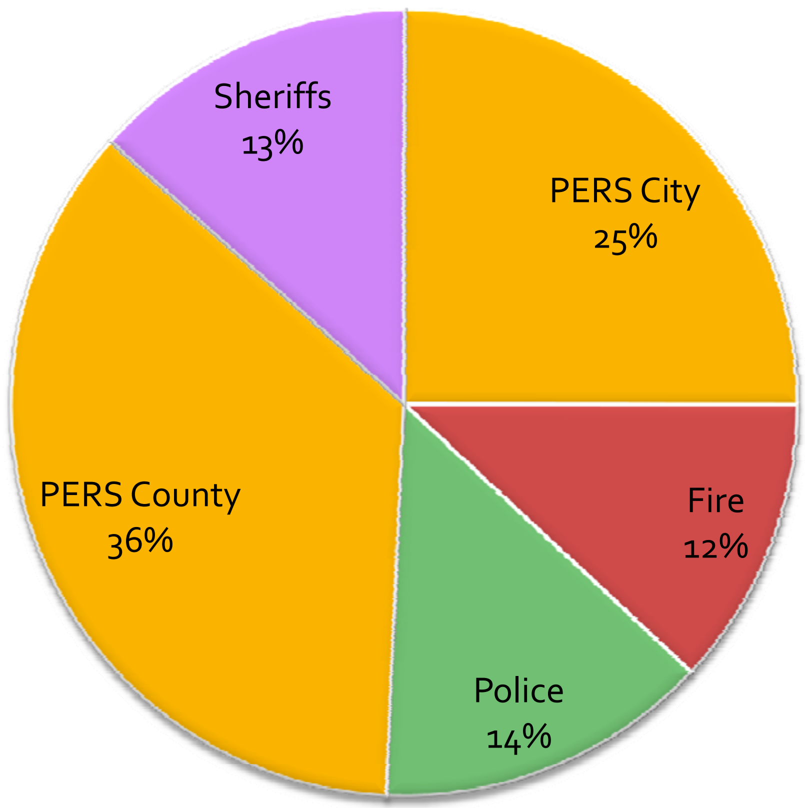
- Allows for comparisons between levels of government
- Not offered as a solution to the problem
- Solutions will likely use a combination of measures to resolve the issues

Local Government: Cities and Counties

Systems

- Counties
  - Sheriffs
  - PERS
- Cities
  - Fire
  - Police
  - PERS

Total City & County Employer Contributions

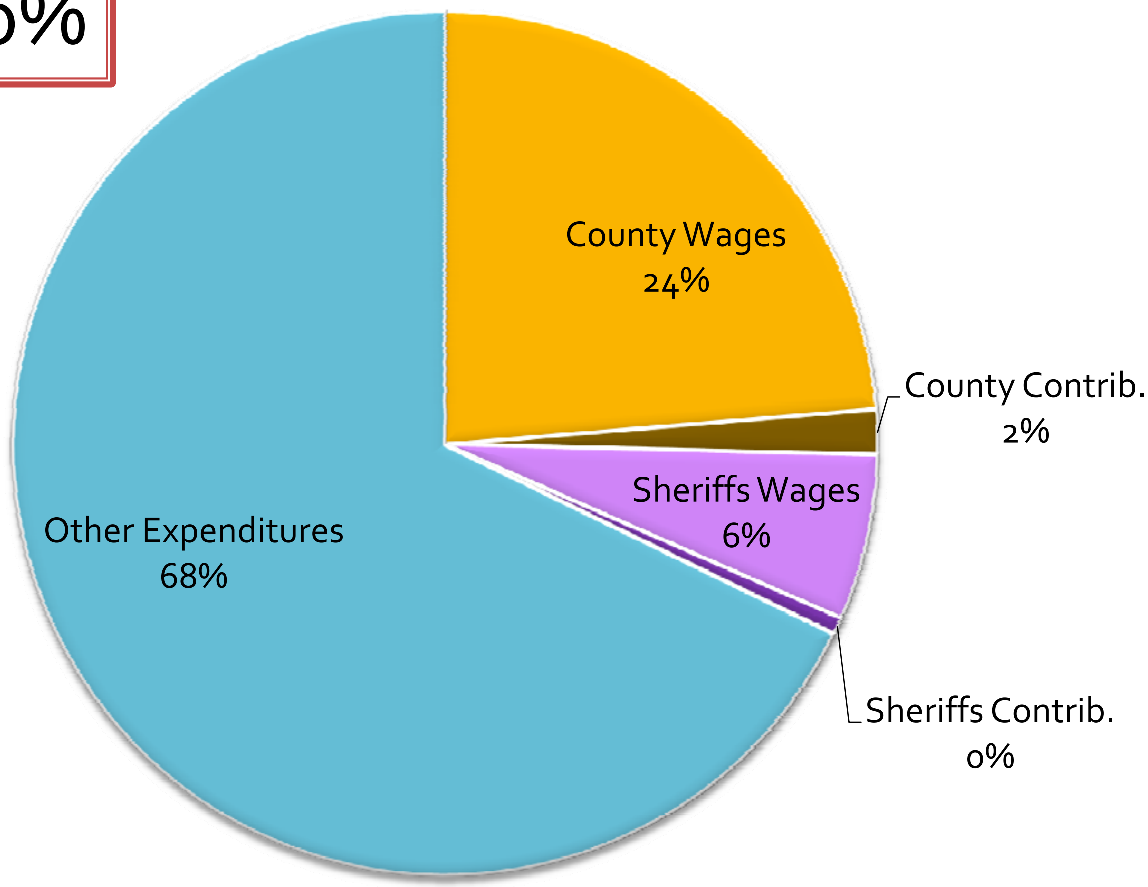


Budgets

- Wages and retirement contributions as a share of local government expenditures
- Property tax as a share of local government revenue
- Total share of budgets that could fund the ARC

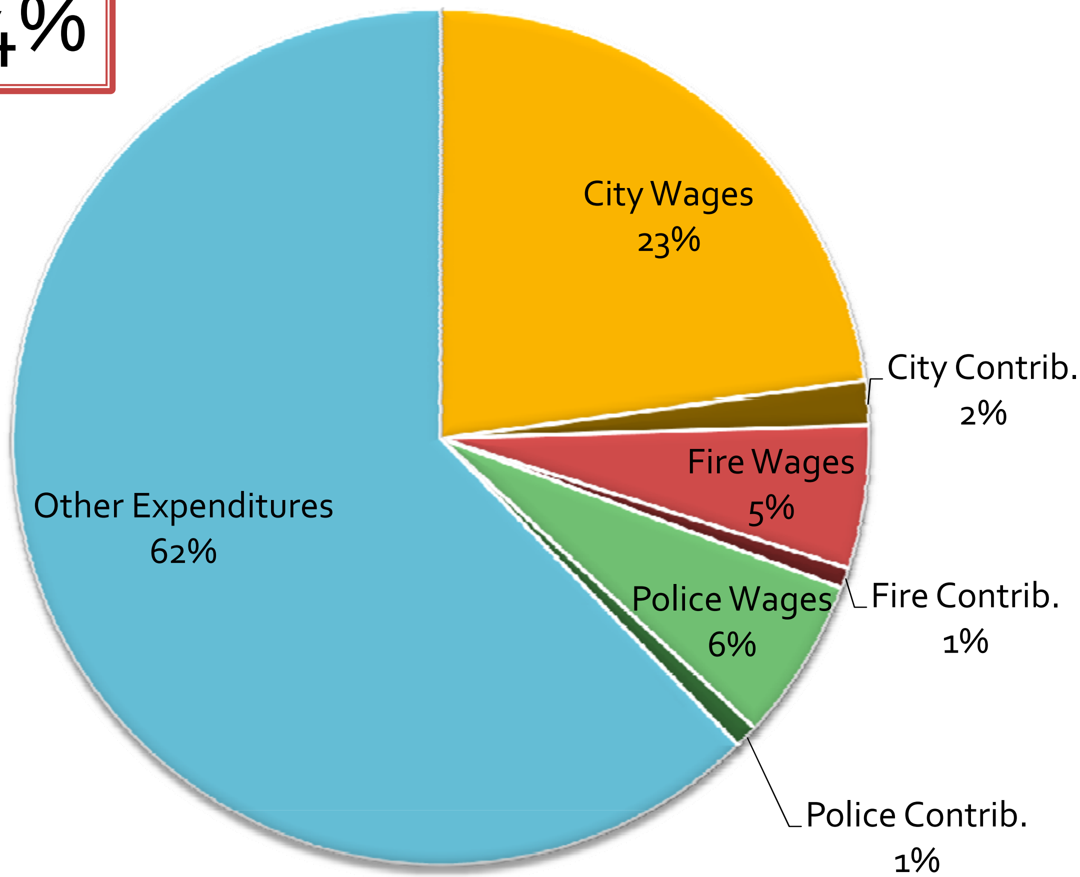
County Wages & Retirement Contributions

Wages = 30%

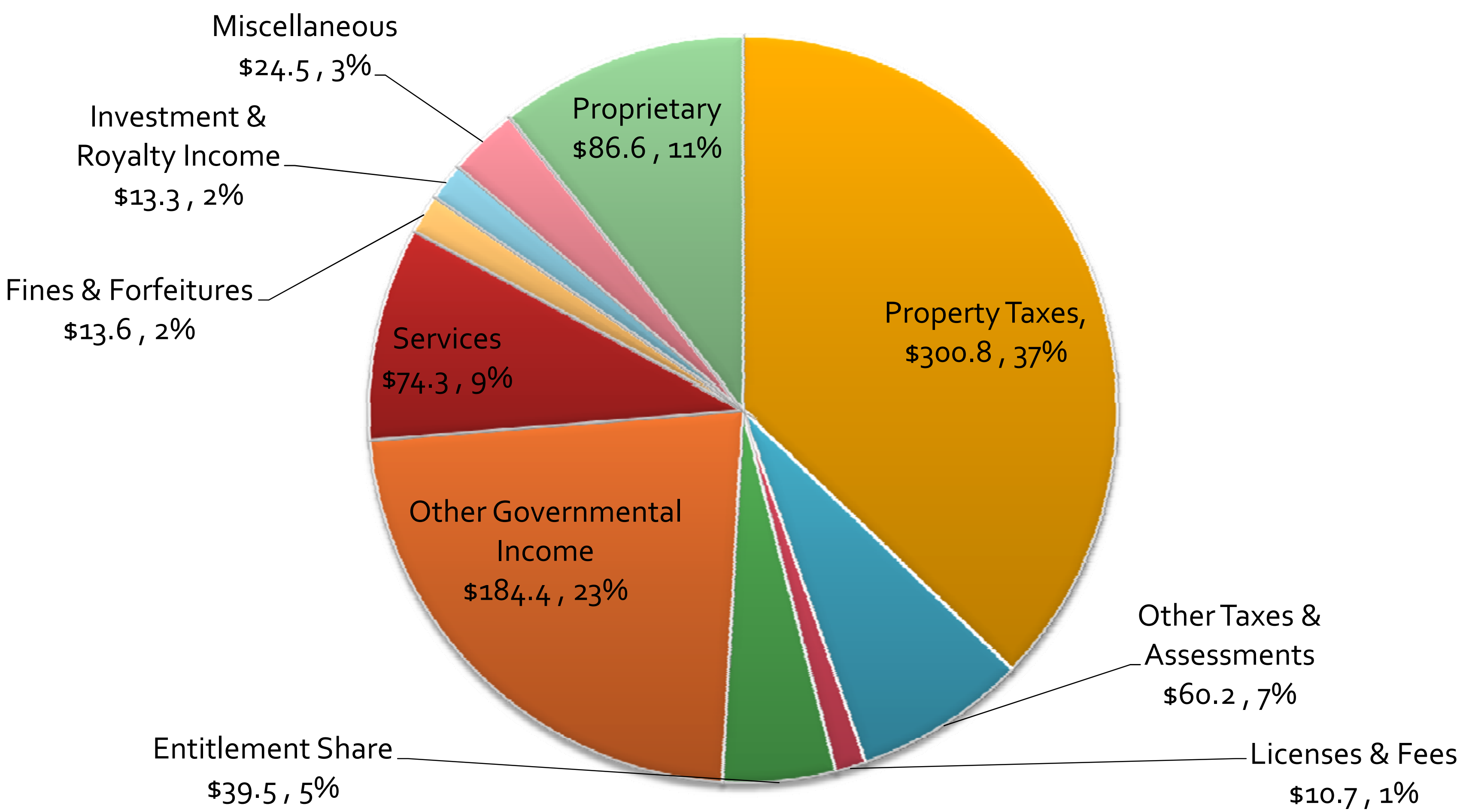


City Wages & Retirement Contributions

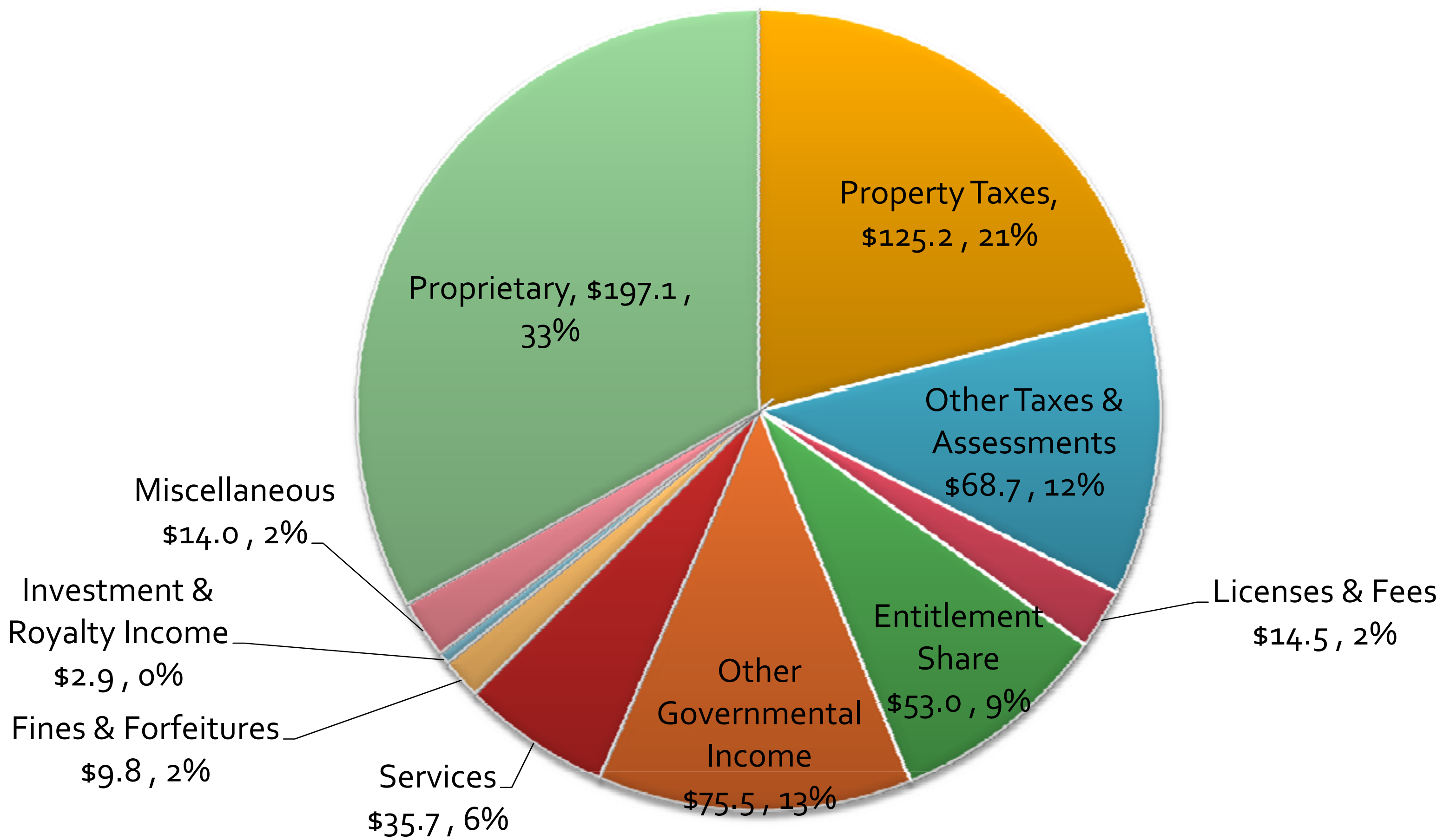
Wages = 34%



Pension Participating County FY 2010 Revenue ($ millions)



Pension Participating City
FY 2010 Revenue ($ millions)



Property Tax Limitations

- MCA 15-10-420 limits the growth in local government levies to half the rate of inflation plus growth in the tax base
- Allows health care cost increases to increase levies
- Allows specific levies for:
  - Judgments
  - Repay taxes paid in protest
  - A declared emergency levy
  - A few others

Entitlement Share

- State payment based on previous tax revenues of local government
  - 5% of County government revenues are entitlement share
  - 9% of City government revenues are entitlement share

Other Funds

- Other taxes and assessments
  - Special projects such as streets, lighting and parks
- Other governmental revenues
  - Oil and gas taxes (in county government data)
  - Gas taxes
  - State and federal grants
- Proprietary funds
  - Water
  - Sewer
  - Solid waste

Estimates of Closing the ARC gap with Employer Contributions

- Cities: 1.1% of annual expenditures
- Counties: 1.7% of annual expenditures
- Under current law counties and cities may be able to increase levies up to the limits of MCA 15-10-420, if they have capacity within the levy
  - Maximum if levies could float to cover all increased costs: $24 million
  - Maximum if levies could float to cover estimated property tax share of increased costs: $7.5 million

Local: Additional Research

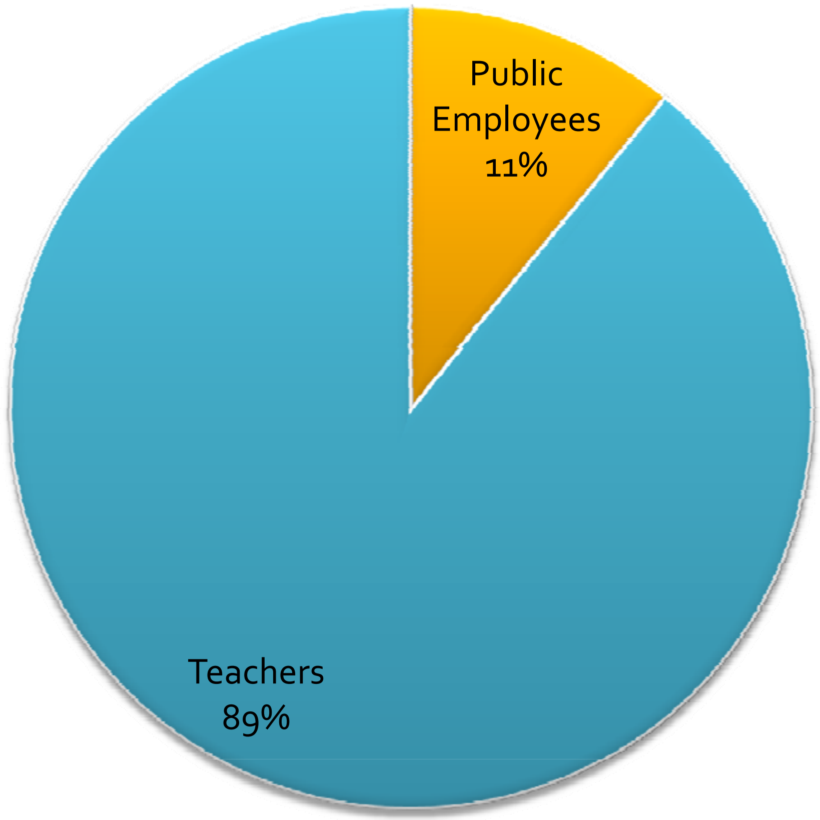
- Refine assumptions
  - Allocate costs based on personal services spending by fund type
  - Investigate the impacts of the increased costs
  - Investigate anomalies
- Meet with local government finance officers to better understand impacts and clarify assumptions

Local Schools

Systems

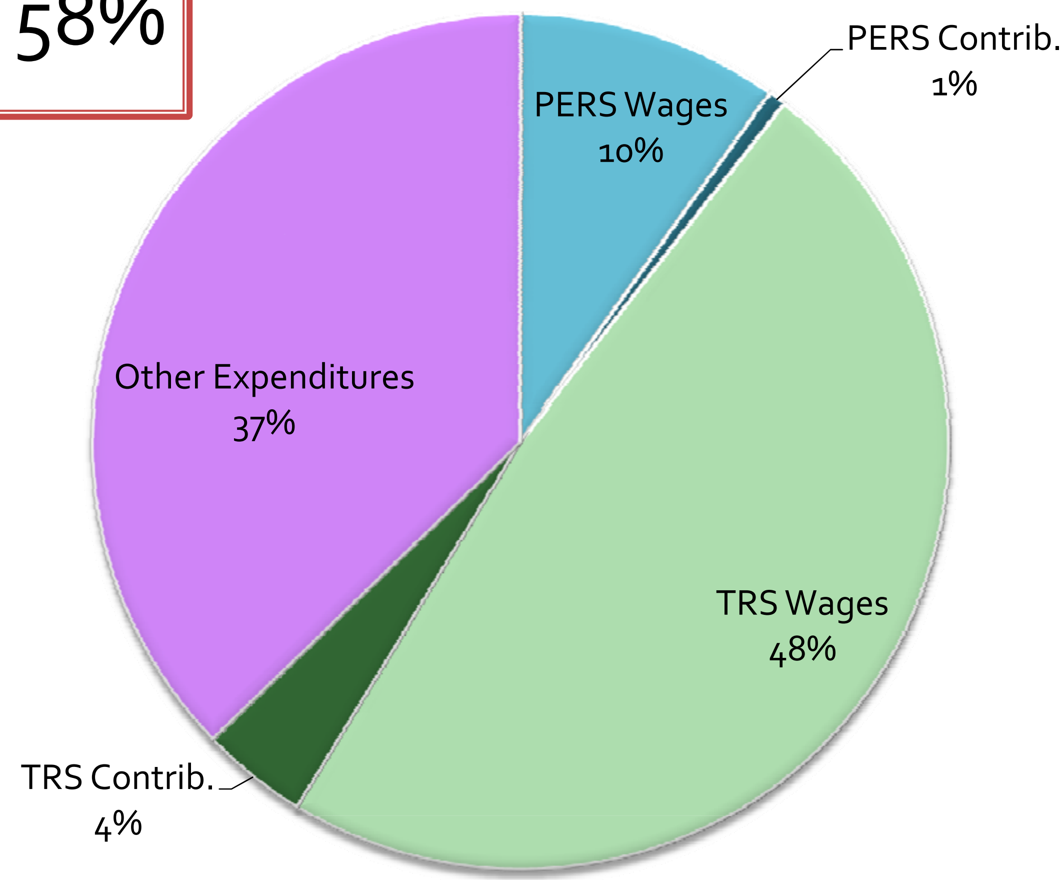
- Schools
  - TRS
  - PERS

Total School District Employer Contributions



School Wages & Retirement Contributions

Wages = 58%



Federal Funds

- Federal funds (other than Impact Aid) are required to fund the pension costs associated with hiring employees funded with federal dollars
- Approximately 12% of all school employer pension contributions are paid with federal dollars

School Funding of 88% of Pensions

- Rolled up to the county level
- First source of funding is non-levy revenue
- After that, Guaranteed Tax Base guarantees a Taxable Value per ANB that is at least equal to 121% of the state wide average
- Ratio varies by county; on average:
  - State contribution is 28%
  - Local levies fund 72%

Definition of a Quality Education

- MCA 20-9-309 …(2) As used in this section, a "basic system of free quality public elementary and secondary schools" means: … …(d) qualified and effective teachers or administrators and qualified staff to implement the programs in subsections (2)(a) through (2)(c); …

Estimates of Closing the ARC gap with Employer Contributions

- The gap in the ARC if paid with employer contribution rate increase is 2.77% of school district budgets (Page 12 of report)
- Using the current funding formula
  - Federal funds would need to absorb 12% or $4.7 million
  - Local levies would increase $26.2 million
  - State Guaranteed Tax Base aid would increase $9.1 million

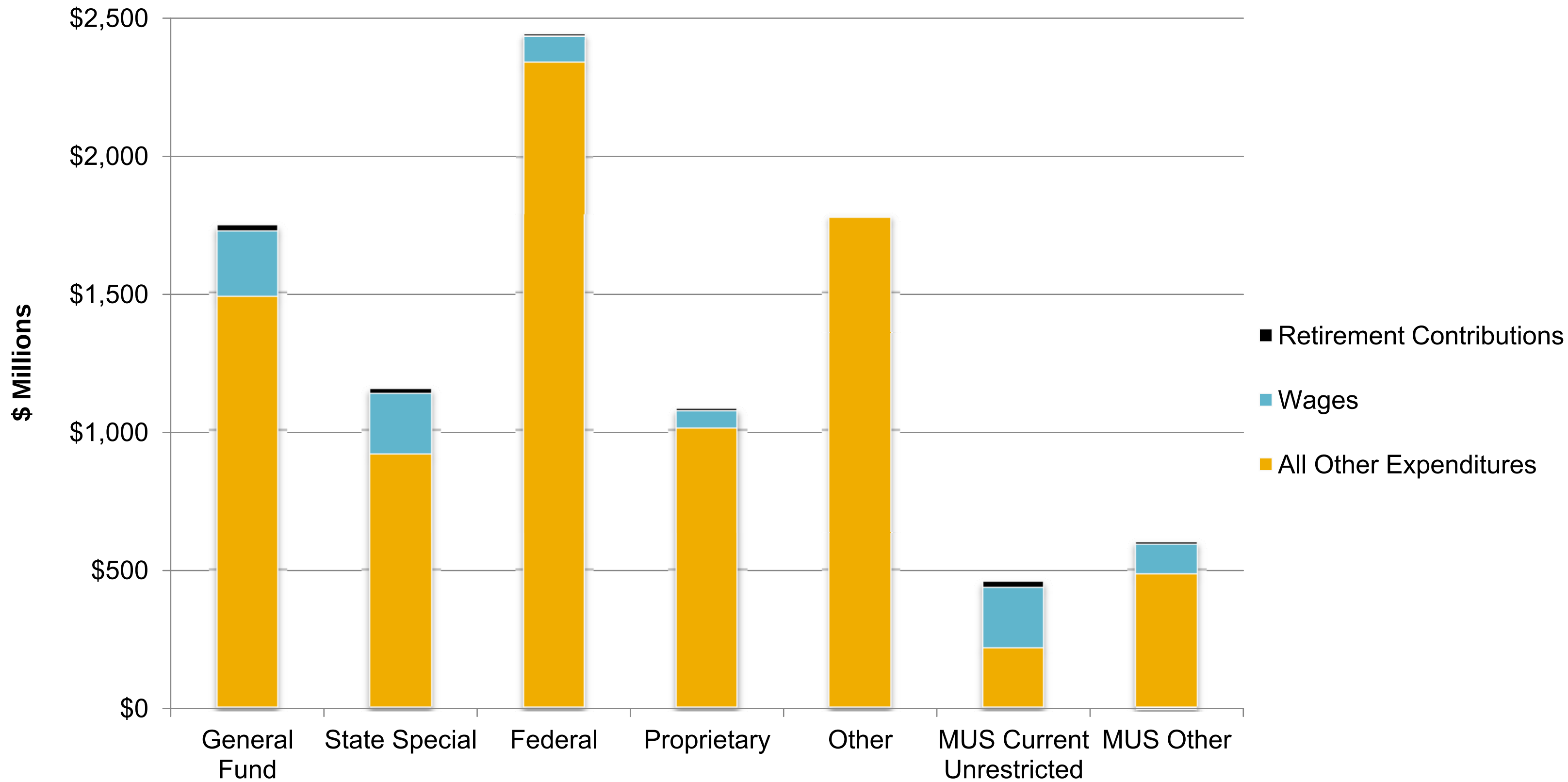
Schools: Additional Research

- Refine assumptions
  - Investigate the impacts of the increased costs to federal funds
  - Investigate anomalies
- Meet with school district finance officers to better understand impacts and clarify assumptions

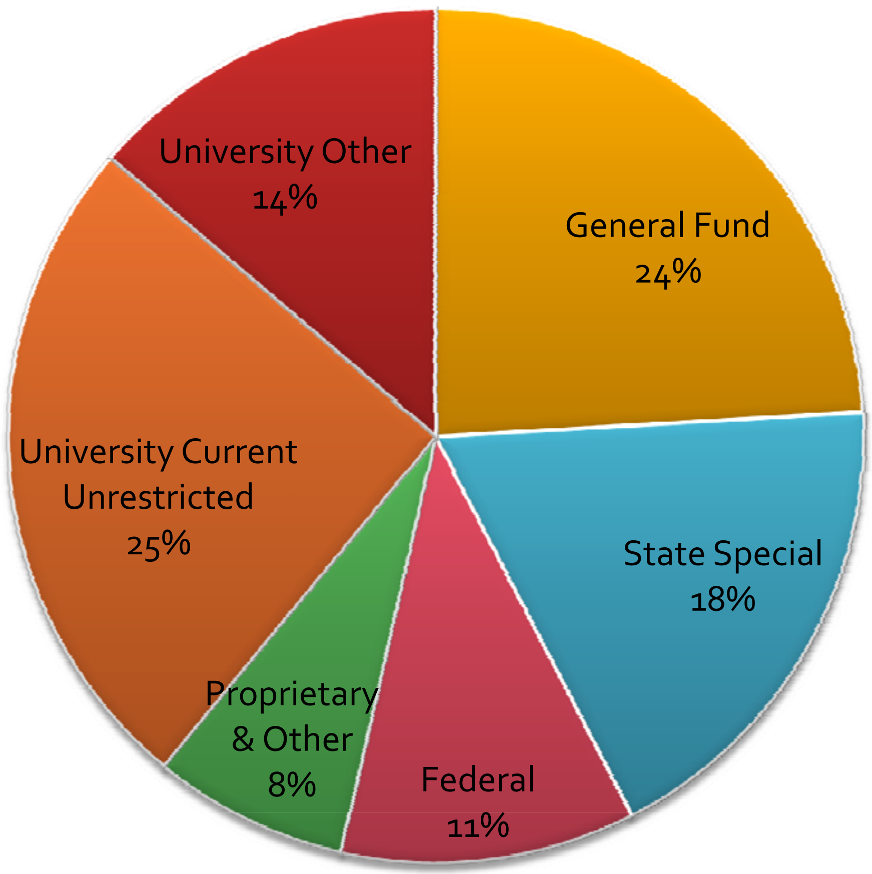
State Government

State Wages & Retirement Contributions

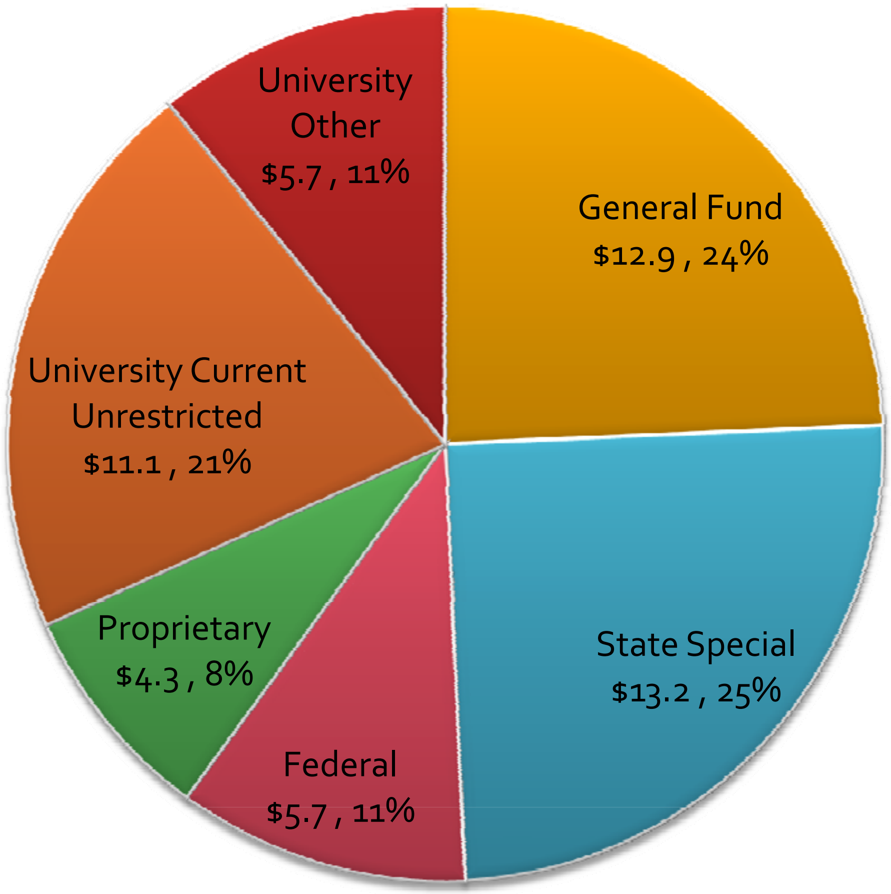
Wages = 8%



FY 2011 State Funding of Wages & Retirement



State Impact of Meeting the ARC: FY 2014 Potential Increase ($ millions)



Total General Fund $19.3 million for state employees (note GTB is additional):

- ✓$12.9 million GF employees,
- ✓$1.4 million proprietary employees,
- ✓$5.0 million MUS employees

State: Additional Research

- Refine assumptions including:
  - Investigate anomalies
  - Share of Proprietary and MUS funding to be paid by general fund
- Which state special and federal funds would be impacted the most and what would increased employer contributions mean for services?
- What impacts, including tuition rates, might be felt throughout the Montana University System?

Summary

Risk Summary

- ROI Asset Allocation
- Long-term viability without changes
- ROI future growth potential
- Shifting liability to all plan employers
- From September meeting: Changing landscape of measurement and analysis will influence public perception

Summary of Employer Contribution Impacts

- State General Fund: $28.4 million
  - $12.9 million state general fund employees
  - $1.4 proprietary employees
  - $5.0 million MUS employees
  - $9.1 million school employee GTB aid
- Other MUS funds: $11.8 million
- Other state funds: $21.8 million
- School property taxes: $26.6 million
- Local government costs $24.0 million

Next Steps

- March Meeting
  - Comparisons to other states funding status if any updates are available
  - What other states have done to resolve their issues and what that could look like in Montana
  - Legal status: can the state shift the liability to employees/retirees?
  - Total debt perspective: State/MUS/Schools/Local
  - Additional direction from the LFC
- June Meeting
  - Review potential solutions
  - Joint meeting with SAVA
  - Follow up on additional research