APPENDIX A

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Montana Legislative Services Division

Legal Services Office

LEGAL MEMORANDUM

TO: Members, State Administration and Veterans' Affairs Committee and Legislative Finance Committee

FROM: David Niss, Staff Attorney

RE: Recent Developments in Pension Case Law and Proposals

DATE: May 21, 2012

I
Introduction

Since I advised the State Administration and Veterans' Affairs Committee (SAVA) and the Legislative Finance Committee (LFC) on the subject of the importance of the case law dealing with alternatives to any legislation that impairs the employment/retirement pension contracts of government employees[1] and made presentations to both Committees,[2] more decisions by trial and appellate courts have come to light holding various pension-impairing legislation to be unconstitutional because that legislation impaired employment/retirement contracts. Also, since those presentations, the Governor has proposed his own program for shoring up the PERS and the TRS. Finally, the LSD and LFC staff have prepared several written scenarios for shoring up those retirement systems. The purpose of this memorandum is to review those judicial decisions and the Governor's proposal and give both Committees additional detail on the constitutionality of those budget scenarios that contain provisions that may impair employment/pension benefit contract.

II
Discussion

A. The Importance of the U.S. Trust Opinion

As pointed out in an earlier memorandum on this subject,[3] the language of U.S.

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[1]Legal Memorandum dated January 5, 2012, "Constitutionality of Amendment of GABA Statutes to Tie Amount of GABA to State Investment Earnings for Current Retirement System Members", from this author to the State Administration and Veterans' Affairs Committee and the Legislative Finance Committee.

[2]The author appeared before the SAVA Committee on January 27, 2012, and before the LFC on March 8, 2012, and discussed the cited memorandum and the recommendations in the memorandum.

[3]Id, p. 2.

Trust Company of New York v. New Jersey, 431 U.S. 1 (1977) ("U.S. Trust") is highly important and even controlling. In that opinion, in short, the Court held that an impairment will be held unconstitutional if: (1) the impairment is a "substantial" impairment, in other words, not a "technical impairment",[4] and (2) the government enacting impairing legislation does not first at least seriously consider nonimpairing or lesser impairing legislation. Mr. Justice Blackmun wrote:

> But a State is not completely free to consider impairing the obligations of its own contracts on a par with other policy alternatives. Similarly, a State is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well.

Because of this language in the U.S. Trust opinion, courts considering impairing legislation have focused on whether the impairment was "substantial" and whether other nonimpairing alternatives, or less drastic impairments, were at least genuinely considered by the government, if not actually enacted, first.[5]

B. The Importance of the Record in the Case Law

There is no unanimity in judicial opinions subsequent to the Supreme Court's opinion in U.S. Trust whether the alternatives to impairment discussed in that opinion must actually be tried, i.e., enacted, or just studied and rejected by the government. What is clear from the language of the U.S. Trust opinion and opinions in subsequent

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[4]There is little question that a reduction in the GABA would be held to be a substantial impairment. The Ninth Circuit has held that a contract impairment is substantial if it minimally alters a financial term of the agreement. In S. Cal. Gas Co. v. City of Santa Anna, 336 F.3d 885 (9th Cir. 2003), the Ninth Circuit held that the application of a 3-day delay in payment over six different time periods was a substantial impairment. Interestingly, in this case, the Ninth Circuit noted: "In the last thirty-five years, no Ninth Circuit or Supreme Court case has found a statute or ordinance necessary when the law in question altered a financial term of an agreement to which a state entity was a party."

[5]The contract clauses of both the U.S. and Montana Constitutions protect only contract rights that have become vested. This concept, especially as to amendment of the statutory contracts created by section 19-2-502(2) or 19-20-501(6), MCA, or Montana Supreme Court opinions, has not been dealt with definitively by that court. For example, Montana Supreme Court opinions have held that the contract "arises" when the employee begins work, but section 19-2-502(2), MCA, provides that the statutes forming the contract may be amended to provide further benefits under the contract to the employee. Other courts outside Montana have held that amendments of the employment/retirement pension contract vest when the employee keeps working following the amendment of the contract and, thereby, accepts the new contract provision and provides the *quid pro quo* as consideration for the increased benefit. However, the Supreme Court also said, in Gulbrandson v. Carey, 272 Mont. 494, 502 P.2d 573 (1995), that "[t]he terms of Gulbrandson's retirement benefit contract are determined pursuant to the statutes in effect at the time of his retirement...". Taken literally, this statement would allow amendment of the retirement pension contract up to the day on which an employee retires. However, there is no indication in section 19-2-502(2) or 19-20-501(6), MCA, that the statutory terms of the contract become effective on any date other than the effective date of the statutes.

cases relying upon U.S. Trust, however, is that *impairing alternatives cannot be the first or only solution that the government resorts to and that a government that imposes impairment first without either enactment or serious analysis and consideration of, first, nonimpairing alternatives and, secondly, less drastic impairments, will not see the impairing legislation upheld in legal action applying the U.S. Trust test for constitutionality of impairment of contracts.* Several judicial opinions, two issued since the last memorandum on this subject, make this point.

In AFL-CIO-CLC v. Government of the U.S. Virgin Islands, 2012 U.S. Dist. LEXIS 43461 (March 29, 2012), the U.S. District Court held that by enacting several cost-cutting measures, including raising taxes and fees, in order to cure projected deficits ranging from $17 million to $90 million per year over a 3-year period, seeing those measures prove insufficient, considering other plans to reduce spending (including layoffs, elimination of paid holiday leave, work furloughs, and a gross receipts tax increase), and finally, as a last resort, reducing government employee salaries by 8% for a limited period of time, the Virgin Islands Legislature, Governor, and other defendants had not acted unconstitutionally under the standards of the U.S. Trust opinion. The Virgin Islands case is one of a very small number of cases approving a financial impairment for government employees.

In Williams v. Scott, case no. 2011 CA 1584, Circuit Court of the Second Judicial Circuit for Leon County, Florida (March 6, 2012), the Court held that it was insufficient for the state to show that there were significant budget shortfalls in order to justify the elimination of a 3% cost of living adjustment because (a) employers were given a substantial decrease in the amount of their contributions, and (b) the Legislature left a positive $1.3 billion balance in the state general fund. There was nothing in the record reviewed by the Circuit Court to indicate why the Legislature had impaired the contracts while actually reducing employer contributions and leaving such a strong cash balance in the general fund.

In the case of United Firefighters of Los Angles City v. Los Angeles,[6] in which the city adopted a 3% cap on cost of living adjustments and the plaintiffs claimed an impairment of their contract, the California Court of Appeals said, in reviewing the alternatives to the cap, that "...in adopting cost-cutting measures to further an important public purpose, there must be some indication the public entity has given considered thought to the severity of the effect an enactment might have on the particular contractual scheme at issue and to the possibility of alternative, less drastic, means of accomplishing the public goal."

[6]210 Cal. App. 3d 1095, 259 Cal. Rptr. 65 (1989).

Finally, in University of Hawaii Professional Assembly v. Cayetano,[7] the Ninth Circuit Court of Appeals pointed out, in striking down a pay lag as an unconstitutional impairment of contract, that "Defendants have not explained why it is reasonable and necessary that the brunt of Hawaii's budgetary problems be borne by its employees."

These opinions indicate that if the Legislature is going to choose a remedy to repair the effect of the market losses in the assets of the retirement funds that impairs employees' employment/retirement pension contracts by eliminating or altering the GABA or other retirement benefits for existing members of those funds (active or retired), the impairing legislation would stand the best chance of being upheld under the U.S. Trust standard if the Montana Public Employees Retirement Board or other defendant in a contract impairment lawsuit could rely upon a demonstrable rationale of the Legislature for enacting the impairing legislation. The very best source of this rationale, which would explain why various nonimpairing alternatives were perhaps not chosen, is the official records of the Legislative Committee(s) recommending or reviewing the impairing legislation. The same judicial opinions, and therefore the same reasoning, apply to the choice of a larger impairment over a smaller impairment and also apply no matter what the source[8] of the impairing legislation is.

C. The Governor's Proposal and the "California Rule"

On April 10, the Governor proposed, at a press conference in the Governor's reception room, that both the TRS and PERS could achieve actuarial balance by tapping several sources of funding, among them a 1% increase in employee contributions for both retirement systems, but no increase in benefits for the members of either system.

In 1973, then Attorney General Woodahl issued an opinion to Mr. Larry Nachtsheim, a former administrator of the Montana Public Employees' Retirement System, holding that because the relationship between the state and its game wardens regarding wardens' retirement benefits was contractual and game wardens were obligated by statute to pay only 7% of their compensation to the Game Wardens' Retirement Fund, any additional 1% contributions to the Fund had to be made by the state and not by the wardens, unless the wardens received an advantage comparable to the 1% increase in additional contribution. The only support for this proposition, that a retirement pension contract may be impaired if a comparable advantage is also given,

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[7] 183 F.3d 1096 (1999).

[8] In other words, if the Legislature enacts contract-impairing legislation, in order to provide the best chance that the legislation would be sustained, the legislative history should show the basis for any choice of impairing legislation over nonimpairing legislation no matter what the source of the legislation is, whether that source is an interim committee bill, a standing committee bill, or an individual member's bill.

is language in Clarke v. Ireland,[9] in which the Montana Supreme Court held:

> It is true that the public interest in retirement funds and retirement programs for employees and public officers alike demands that those in charge of the funds be constantly watchful of the integrity of the fund. Changes in interest rates, increase in the life span of the employees, experience in the operation of the retirement program, may require changes to insure that all the members of the system have the benefits which they have contracted for. Great latitude should be permitted the legislature in making alterations to strengthen the system. But such changes are subject to the above constitutional limitations. If the legislature is convinced of the need to safeguard and protect the fiscal base of the retirement system and plans changes to maintain the solvency of the system it must legislate within the framework of the Constitution.

From the foregoing quote it can be seen that there is nothing in Ireland that clearly and expressly adopts what has been referred to in previous legal memorandums on this subject[10] as the "California rule".[11] The Ninth Circuit Court of Appeals has, however, used this approach.[12]

The Ninth Circuit Court of Appeals has sanctioned the use of the California Rule approach to increasing contributions from employees. So if the California rule were applied by the courts to judge the constitutionality of the Governor's April 10 proposal, the principal question that must be asked is, "What is the comparable benefit to the employees?" Because no increase in benefits was proposed by the Governor, the apparent answer is that the comparable benefit is the actuarial soundness of the retirement systems themselves. Several courts have considered the issue of whether the actuarial soundness of a retirement system is sufficient justification for impairment of a contract but have held that justification to be insufficient. In both Ass'n of Penn. St. College and Univ. Faculties v. St. Syst. of Higher Ed.[13] and Singer v. City of Topeka,[14] the Supreme Courts of Pennsylvania and Kansas, respectively, considered and rejected this claim, holding that the strengthened retirement systems gave no specific advantage

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[9]122 Mont.191, 199 P.2d 965 (1948).

[10]Memorandum of August 14, 2009, page 6.

[11]One of the first reported cases from California to adopt the "California rule" was Allen v. City of Long Beach, 45 Cal.2d 128, 287 P.2d 765 (1995).

[12]See, e.g., State of Nevada Employees Ass'n, Inc. v. Keating, 903 F.2d 1223 (9th Cir. 1990).

[13]479 A.2d 962 (1984).

[14]227 Kan. 356, 607 P.2d 467 (1980).

to the plaintiffs in those cases.[15] And in Barnes v. Ariz. St. Ret. Syst., CV 2011-011638 (Superior Court of Ariz., Maricopa County, 2012), the Court stated: "By paying a higher proportionate share for their pension benefits than they had been required to pay when hired, Plaintiffs are forced to pay additional consideration for a benefit which has remained the same." Based upon these opinions, there is little reason to suspect that a unilateral increase in a current retirement system member's contribution rate, at least when there has been no corresponding increase in any tangible benefit to the same member, will be treated by the courts any differently than a unilateral reduction in retirement benefits for current members.

D. The Five LSD/LFD Pension Plan Funding Scenarios

The staffs of the Legislative Services Division and the Legislative Finance Division have devised five scenarios for making the actuarially required funding payments to pay off the unfunded liability that now exists beyond the 30-year goal. Scenario Number 1, making the payments only with increased employer contributions, involves no constitutional impairment of contract issues. Scenario Number 2, making those payments with increased employer and employee contributions, raises constitutional impairment of contract issues if those increased contributions come from current members (working or retired) of the retirement systems whose right to a retirement benefit has already vested. To the extent that those increased contributions are required from current members of the systems whose right to a retirement pension benefit has become a vested contract right, the opinions noted in the foregoing paragraphs concerning the Governor's proposal indicate that requiring increased contributions impairs the state's contract with its employees and would be held unconstitutional, at least without a comparable increase in another benefit under the "California rule", pursuant to Article I, sec. 10, of the U.S. Constitution and Article II, section 3, of the Montana Constitution as well.[16]

Funding Scenario Number 3 involves no impairment of contract issues. Scenario Number 4 is the most clearly problematic scenario of the four alternatives if it is applied to current members of the retirement systems because it involves the elimination of a pension contract benefit, the GABA, that both federal and state courts have indicated would be a violation of the respective contract clauses of the federal and state

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[15]However, the Supreme Courts in both cases did not address the issue whether strengthening the retirement systems could provide an off-setting advantage for different plaintiffs.

[16]There is, additionally, some question as to whether a vested benefit may, as a matter of both contract and statute, be reduced at all, or at least without amending section 19-20-501(6), MCA, which seems to indicate that only "enhancements" may be applied to a vested contract. This provision, as well as the "enhancement" itself, may now be a part of the contract of many public employees. No reported Montana cases have dealt with these issues.

constitutions, as indicated in the January 5, 2012, memorandum.[17]

Funding Scenario Number 5 is a generic scenario intended to address other possible funding methods not described by the previous four scenarios. To the extent that those other scenarios whose exact terms or provisions are not addressed in the previous four involve an impairment of vested contract rights, the legal analyses accompanying the previously discussed Scenarios Number 2 and 4 are likely to apply.

III
Conclusion

If legislation is enacted impairing vested rights under contracts established by section 19-2-502 or 19-20-501, MCA, or as found in the jurisprudence of the Montana Supreme Court, and that legislation is tested by the courts under the impairment of contracts standard adopted in U.S. Trust Co. v. New Jersey, the constitutionality of the impairment will depend upon whether the impairment is substantial and what alternatives were first enacted or seriously considered and rejected by the Legislature. If nonimpairing alternatives are not adopted by the Legislature before substantial impairing alternatives, whether a substantial impairment is held constitutional is likely to depend upon the extent to which nonimpairing alternatives, or lesser-impairing alternatives, were analyzed and seriously considered by the Legislature. In other words, that question will turn upon the breadth, detail, and strength of the analysis of nonimpairing or lesser-impairing alternatives by the Committees, as reflected in the records and reports of the Committees and their staff. It is also possible that the courts might uphold a substantial impairment that has been chosen over nonimpairing alternatives, or a lesser impairment, if the impairment is offset by other benefits enacted by the Legislature.

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[17]See footnote no.1. While it was not mentioned in that memorandum, this writer did mention in the oral presentation to both Committees the Ninth Circuit Court of Appeals case of University of Hawaii Professional Assembly v. Cayetano, supra, note 6.

Appendix B

LONG-TERM PLANNING GOALS & FRAMEWORK FOR ANALYSIS

Prepared by Sheri Scurr and Dave Bohyer, Legislative Services Division

June 2012

In review

The report presents analyses of five hypothetical Scenarios to possibly meet the Actuarially Required Contributions or "ARC" for the state's defined benefit (DB) retirement plans and, ultimately, to extinguish unfunded pension liabilities. The legal analysis emphasizes that with certain benefit and funding changes, contract impairment issues arise and that before the legislature enacts legislation that raises contract impairment issues, non-impairing alternatives should be thoroughly analyzed and considered, if not enacted. The policy analysis compares benefit and funding changes to policy principles adopted by SAVA and, regarding Scenario 5, the wholesale shift in state retirement policy. The fiscal analyses assume a goal of immediately achieving a 30-year amortization period using ARC funding for the state's DB retirement plans' unfunded liabilities and illustrates the fiscal and financial consequences and implications for state and local governments. The fiscal analyses also point out that there are inherent risks when relying on actuarial assumptions and that new GASB standards offer an alternative way to view the fiscal health of DB retirement plans. Taken together, the analyses offered in the report highlight the indication that the legislature should consider establishing short-term and long-term goals to use as benchmarks against which legislative proposals can be measured in ways that more fully inform the legislature and stakeholders about whether a particular proposal helps or hinders in reaching the goals.

Purpose

The purpose of this appendix is to present actuarial funding and benefit policy benchmarks as a starting point for further analysis and discussion. This appendix is also designed to provide the legislature with the opportunity to thoroughly analyze benefit changes and funding alternatives that do not raise contract impairment issues and to ensure that legislative consideration and discussion of the non-impairing alternatives is part of the public record. Finally, this appendix can provide a framework to help SAVA complete its statutorily required analysis of and report on proposed retirement legislation reviewed prior to the session.

Guiding principles

The material presented in this appendix is framed by the following two policy principles adopted by the State Administration and Veteran's Affairs Interim Committee (SAVA) pursuant to section 5-5-228, MCA:

1. A retirement plan should provide a foundation for financial security in retirement.
2. Pension funding should be a contemporary obligation.

Organization

This appendix is organized as follows:

Tables B1 through B7 - Amortization goals by retirement plan

Tables B8 and B9 - Minimum benefit parameters for new hires

Table B10 - Benefit change alternatives for new hires only

Table B11 - Template for funding source analysis

Next Steps

The last page of this appendix presents questions that, if answered by committee action, would allow legislators and other to pursue further analysis of benefit and funding alternatives that do not raise contract impairment issues.

HYPOTHETICAL AMORTIZATION GOALS AND TABLES B1 THROUGH B7

Policy Principle Adopted by SAVA: Pension Funding Should Be a Contemporary Obligation.

***Purpose*:** Tables B1 through B7 were created based on the pension funding policy principle adopted by SAVA that funding should be a contemporary obligation. To begin the discussion, the tables set out for each retirement plan a 15-year schedule for reaching a 30-year amortization period and a 30-year plan for achieving 100% funding with a 15% cushion for actuarial fluctuations and the ultimate goal of a 100% or better funded ratio. To be considered "contemporary" in a 30-year retirement plan, the benefits for a new hire should be fully paid for within 30 years of the member's hire date. Contemporary funding of unfunded liabilities means:

(1) a short-term goal of not overburdening current taxpayers which could be caused by having too short a schedule for achieving actuarial soundness while maintaining the longer-term goal of full funding;
(2) not pushing funding obligations too far into the future by having too long of a schedule; and
(3) ensuring plan assets that are sufficient to pay benefits and that keep the plan's funded ratio at 80% or better.

The information in Tables B1 - B7 illustrate how the legislature could approach establishing a long-term funding plan to reach a policy goal of 100% funded, by setting hypothetical target amortization periods. After target amortization periods are set, then the legislature can request actuarial analysis to determine funding needs and how the plan's funded ratio will be affected.

***Definition*:** For the purposes of Tables B1 - B7, the term "Required Additional Funding" or RAF is the amount of money (as a percent of salary) needed **in addition to** all actuarially assumed contributions to pay off unfunded liabilities by the end of the target amortization period.

Investment return assumption: At the national level, actuaries, economists, and government finance officers are debating what investment return assumptions to use when calculating funding needs. The actuarial analysis required to determine the RAF can be based on any investment return assumption SAVA or the legislature wants to consider. However, as a starting point for discussion, the RAF should be calculated using the current rate of return assumption of 7.75% because it is the rate set (constitutionally) by the retirement board as of the latest actuarial valuation, June 30, 2011. If, however, the FY 2012 actuarial valuation determines that a lower investment return assumption should be used for the next 30-year period or a legislator, a legislative committee, or another stakeholder wishes to adopt a funding schedule shorter than 30-years, the investment rate of return assumption used to perform the actuarial analysis for Tables B1 - B7 should be adjusted accordingly.

Notes: In Tables B1 through B7:

** means actuarial analysis is needed to match the RAF with the target amortization period
x % means actuarial analysis is needed to determine what the plan's funded ratio will be if the RAF is met

Table B1

TRS	2011 Valuation	2015	2020	2025	2030	2035	2040
Target Amortization Period	71 yrs	65 yrs	45 yrs	30 yrs	20 yrs	10 yrs	0 years -- no unfunded liabilities
Required Additional Funding (RAF)	not applicable	**	**	3.53% (2011 valuation)	**	**	** (for 15% cushion and stabilization fund)
Funded Ratio (market value)	61.5%	x %	x %	x %	x %	x %	100% or more

Table B2

PERS	2011 Valuation	2015	2020	2025	2030	2035	2040
Target Amortization Period	does not amortize	70 yrs	45 yrs	30 yrs	20 yrs	10 yrs	0 years -- no unfunded liabilities
Required Additional Funding (RAF)	not applicable	**	**	6.36% (2011 valuation)	**	**	** (for 15% cushion)
Funded Ratio (market value)	70%	x %	x %	x %	x %	x %	100% or more

Table B3

SRS	2011 Valuation	2015	2020	2025	2030	2035	2040
Target Amortization Period	does not amortize	70 yrs	45 yrs	30 yrs	20 yrs	10 yrs	0 years -- no unfunded liabilities
Required Additional Funding (RAF)	not applicable	**	**	5.22% (2011 valuation)	**	**	** (for 15% cushion)
Funded Ratio (market value)	79.4%	x %	x %	x %	x %	x %	100% or more

Table B4

GWPORS	2011 Valuation	2015	2020	2025	2030	2035	2040
Target Amortization Period	does not amortize	70 yrs	45 yrs	30 yrs	20 yrs	10 yrs	0 years -- no unfunded liabilities
Required Additional Funding (RAF)		**	**	3.8% (2011 valuation)	**	**	** (for 15% cushion)
Funded Ratio (market value)	75%	x %	x %	x %	x %	x %	100% or more

Table B5

HPORS	2011 Valuation	2015	2020	2025	2030	2035	2040
Target Amortization Period	48.2 yrs	40 yrs	35 yrs	30 yrs	20 yr	10 yrs	0 years -- no unfunded liabilities
Required Additional Funding (RAF) *(see note)*	not applicable	**	**	**	**	**	** (for 15% cushion)
Funded Ratio (market value)	61%	x %	x %	x %	x %	x %	100% or more

Note: The Highway Patrol Officers Retirement System (HPORS) receives contributions from driver's license fees that amount to about 10.18% of salary. To conform to best practices, license fee revenue should be credited to the state general fund. If that change is made, either: (1) the employer contribution rate should be increased sufficiently to replace the foregone license fee revenue; or (2) each legislature should appropriate sufficient general fund revenue to replace the foregone license fee revenue.

Table B6

MPORS	2011 Valuation	2015	2020	2025	2030	2035	2040
Target Amortization Period	25 yrs	15 yrs	5 yrs	0 years -- no unfunded liabilities	0 years -- no unfunded liabilities	0 years -- no unfunded liabilities	0 years -- no unfunded liabilities
Required Additional Funding (RAF) *(see note)*	(2.69%)	**	**	**	**	**	** (for 15% cushion)
Funded Ratio (market value)	55%	x %	x %	x %	x %	x %	100% or more

Note: The state general fund supplemental contribution is 29.37%. If actuarial analysis indicates that contributions can be reduced while still meeting these goals, then the supplemental general fund contributions could be reduced.

Table B7

FURS	2011 Valuation	2015	2020	2025	2030	2035	2040
Target Amortization Period	16 yrs	10 yrs	5 yrs	0 years -- no unfunded liabilities	0 years -- no unfunded liabilities	0 years -- no unfunded liabilities	0 years -- no unfunded liabilities
Required Additional Funding (RAF) *(see note)*	(10.51%)	**	**	**	**	**	** (for 15% cushion)
Funded Ratio (market value)	62%	x %	x %	x %	x %	x %	100% or more

Note: The state general fund supplemental contribution is 32.61%. If actuarial analysis indicates that contributions can be reduced while still meeting these goals, then the supplemental general fund contributions could be reduced.

HYPOTHETICAL MINIMUM RETIREMENT PLAN PARAMETERS FOR NEW HIRES AND TABLES B8 AND B9

Policy Principle adopted by SAVA: Pensions should provide a foundation for financial security in retirement

***Discussion*:** The purpose of any retirement plan, whether a defined benefit, defined contribution, or hybrid plan, is to provide the member with income in traditionally recognized "retirement". To assess whether a new retirement plan will meet the policy principle, several questions need to be answered: (1) How much income will the member need from the plan? (2) How will the purchasing power of the member's initial benefit be protected against inflation? (3) How many years should the member have to work to receive a full (unreduced) benefit? (4) At what minimum age should the member have to be before receiving a full (unreduced) benefit? The answers to these questions drive the decision about the amounts members and employers would need to contribute to the plan now and through the member's career to accumulate sufficient assets to provide the income in retirement anticipated under the policy principle. As a starting point for discussion, Table B8 sets out policy parameters that an actuary could use to calculate the retirement income prescribed by the policy principle that a pension should provide a foundation for financial security in retirement. The parameters reflected in Table B8 mark the point at which, if benefits for future members are cut below these lines, the plan would fail to sustain SAVA's adopted principle.

Legal note: This table would apply to new hires only. Any benefit reduction or contribution increases without a respective benefit enhancement for current members would raise contract impairment issues and invite litigation.

Table B8

	% of income at retirement needed to provide a foundation of financial security, and the final salary base	Minimize erosion of benefit's purchasing power after retirement	Years of Service for Normal Retirement	Normal Retirement Age	Vesting Period	Employee contributions as share of the normal cost of benefits	Employer contributions as share of the normal cost of benefits
Minimally acceptable benefits for PERS or TRS	50% of pre-retirement income HAC = average of highest 5 years Plan should provide minimum of 50% of pre-retirement income. Assumes Social Security will replace 20% and personal savings will replace 10% of pre-retirement income. In total, the three sources would 80% of pre-retirement income.	1.5% GABA after 3 yrs Benefit increases after retirement are necessary to keep benefits' purchasing power from eroding and should be pre-funded by contributions and investment earnings. A waiting period longer than 3 years could cause a significant benefit erosion.	30 yrs Reflects the traditional working career of non-public safety public employees. Alternative: "Rule of 90"	Age 67 Reflects policy that retirement age should not be higher than the new Social Security eligibility criteria; Age 67 reflects experience of retirees living longer. Alternatives: Age 67 and vested; or "Rule of 90"	7 yrs Reflects a means to reduce the employer's plan funding risks and risk of turnover. A longer time-period until a member vests in the benefit creates or increases a recruitment risk.	65% of normal cost Reflects the idea that employees should contribute a larger proportion of the normal cost of their benefits because the employer, not the employee, bears the financial and actuarial risks	35% of normal cost Reflects the idea that the employer should contribute a smaller proportion of the normal cost of plan benefits because the employer, not the employee, bears the financial and actuarial risks
Minimally acceptable benefits for public safety retirement systems SRS GWPORS HPORS MPORS FURS	70% of HAC at full retirement, if not covered by Social Security, but 50% of HAC if covered by Soc. Sec. Reflects goal of 80% income replacement and assumption that Soc. Sec. and personal savings will make up difference, noting that members of HPORS, FURS, and MPORS are not covered by Soc. Sec.	1.5% GABA after 3 yrs same as above	25 yrs Reflects adjustment upward from traditional 20-year service career for public safety professionals and the employer's need to retain qualified employees and to reduce plan costs. Also reduces employer's risk created by members retiring earlier.	Age 55 Reflects that in public safety systems, most public safety employees start young but because of job stress retire earlier than non-public safety employees. Adding the age criteria reduces plan costs by reducing the number of years the benefit be paid.	7 yrs same as above	65% of normal cost same as above	35% of normal cost same as above

HYPOTHETICAL BENEFIT CHANGES BY PLAN IF MINIMUM POLICY PRINCIPLE BENEFITS WERE PROVIDED TO NEW HIRES

Purpose: The normal cost of the retirement plan benefits is lower for fewer or less valuable retirement benefits as compared to more valuable benefits. If the normal cost of benefits for new members to a retirement plan is less than the

normal cost for members eligible for a previous, higher level of benefits and if salary-based contributions are held constant for all members, more of the employer contributions could be used to pay off unfunded liabilities. The purpose of Table B9 is to illustrate benefit changes that could be made for new hires and that would lower the normal cost of benefits going forward. These changes are hypothetical, but reflect a minimum benefit level as set out in Table B9. The reason for analyzing these hypothetical benefit changes is that they represent alternatives that the legislature could and perhaps should consider prior to considering alternatives that raise contract impairment issues for current members. The alternatives conform each of the defined benefit retirement plans, except for the Judges' Retirement System, to the minimum benefit policy parameters set forth in Table B8. The Municipal Police Officers' Retirement System (MPORS) and the Firefighters' Unified Retirement System (FURS) are included in Table B9 because, although they were considered actuarially sound as of the 2011 actuarial report, they are not yet fully funded and their respective could status'. Additionally, the legislature has previously desired to keep benefits for the public safety professions more or less equivalent with each other.

Contribution amounts. An actuarial analysis to determine the normal cost of the hypothetical benefits (altogether) illustrated in Table B9 would allow the legislature to measure any longer-term cost savings the alternatives may provide as a result of a lower normal cost and against the long-term amortization goals for each plan as outlined in Table B1 through B7. If actuarial analysis is conducted, the legislature will have a better idea of how much--and how much more--funding would be needed to reach the hypothetical funding and amortization goals and, consequently, would be in a better position to determine whether or not to consider legislation raising contract impairment issues.

Table B9

Retirement Plan	Benefit multiplier and average salary	Post-retirement benefit adjustments	Years of service for normal retirement	Normal retirement age	Vesting Period	Employee contributions	Employer contributions
PERS	• Each year of service credited at 1.66% • HAC = Average of 5 highest years	GABA is effective after 3 years	30 years of service	Age 67 and vested; or 30 years of service	7 years	When the normal cost of benefits for new hires is known, this block will show the employee contribution rate at (a maximum of) 65% of the normal cost and stated as a percentage of salary	When the normal cost of benefits for new hires is known, this block will show the employer contribution rate at (a maximum of) 35% of the normal cost and stated as a percentage of salary plus the amount, as a percentage of salary, necessary to amortize the unfunded liability.
TRS	• Each year of service credited at 1.66% • HAC = Average of 5 highest years	GABA is effective after 3 years.	30 years of service	Age 67 and vested; or 30 years of service	7 years	Same as above.	Same as above.

Table B9 continues on the following page

Retirement Plan	Benefit multiplier and average salary	Post-retirement benefit adjustments	Years of service for normal retirement	Normal retirement age	Vesting Period	Employee contributions	Employer contributions
HPORS	• 2.8% • *No Social Security* • HAC = average of highest 5 years	1.5% GABA after 3 years	25 years	Age 55	7 years	When the normal cost of benefits for new hires is known, this block will show the employee contribution rate at (a maximum of) 65% of the normal cost and stated as a percentage of salary	When the normal cost of benefits for new hires is known, this block will show the employer contribution rate at (a maximum of) 35% of the normal cost and stated as a percentage of salary
SRS	• 2.5% • *Social Security* • HAC = average of highest 5 years	1.5% GABA after 3 years	25 years	Age 55	7 years	Same as above.	Same as above.
GWPORS	• 2.0% • *Social Security* • HAC = average of highest 5 years	1.5% GABA after 3 years	25 years	Age 55	7 years	Same as above.	Same as above.
MPORS **Actuarially sound as of 2011 valuation*	• 2.8% • *No Social Security* • HAC = average of highest 5 years	1.5% GABA after 3 years	25 years	Age 55	7 years	Same as above.	Same as above.
FURS **Actuarially sound as of 2011 valuation*	• 2.8% • *No Social Security* • HAC = average of highest 5 years	1.5% GABA after 3 years	25 years	Age 55	7 years	Same as above.	Same as above.

POSSIBLE NEXT STEPS

After considering the benefit and funding goal alternatives presented in this report, the LFC, the SAVA, or an individual legislator may want to provide direction to staff by answering the following questions:

1. Does the committee/legislator want to start with the amortization period goals outlined in Tables B1 through B7?
   - If the answer to Question 1. is: (a) "Yes", then go to Question 3; or (b) "No", then go to Question 2.

2. Does the committee/legislator want to start with amortization period goals different from the goals outlined in Tables B1 through B7?
   - If the answer to Question 1. is: (a) "Yes", specify the amortization goal for each plan, then go to Question 3; or (b) "No", stop here and explore other approaches.

3. Does the committee want to ask system actuaries to determine what the "required additional funding" target or RAF would be in order to meet the amortization period goals identified under Question 1.a. or 2.a.?
   - If the answer to Question 3 is: (a) "Yes", then go to Question 4.; or (b) "No", stop here and consider what information is needed to proceed.

4. Provide a specific answer to the following question:

   a. The current rate of return assumption is 7.75% annually. What rate of return does the committee/legislator want to use for purposes of analysis only? _____ (specify)

   b. A hypothetical range of benefits and pension plan criteria is provided in Table B9. What specific changes, if any, to the hypothetical benefits or pension plan criteria provided in Table B9 does the committee/legislator want to use?
   _____ (specify)
   _____ (specify)
   _____ (specify)
   _____ (specify)

Table B10 on the following pages provides a hypothetical time line for amortizing each pension plan's unfunded liability. The line for "required additional funding" is a number, stated as a percentage of salary, that the actuarial valuation by incorporating the answers from the questions above can produce. Once the percentage-of-salary number is known and plugged in to the required additional funding line, the subsequent blocks underneath the percentages can be filled in by identifying the portion of the percentage to be contributed from whatever sources the committee/legislator wants.

TEMPLATE FOR HYPOTHETICAL FUNDING AMOUNTS AND FUNDING SOURCE ANALYSIS

Purpose: When completed, Table B10 can illustrate how various funding sources could be used to meet the amortization period goals outlined in Tables B1 and B2 for each pension plan. (Other amortization period goals could be substituted for the goals listed from Tables B1 or B2.) The table uses PERS and TRS as examples, but will work with any of the pension plans. When the legislature is considering changes to the retirement plans, this type of chart could be created for each pension plan proposed for change and used to show how much money (as a percent of salary or as a dollar amount) would have to come from the funding sources listed to meet amortization period goals. The numbers used in these tables are strictly hypothetical examples. If actuarial analysis is requested as outlined in Tables B1 through B7, actual numbers could be filled in.

** means actuarial analysis needed to match RAF with amortization schedule goals

	PERS	As of FY 2011 Valuation	As of FY 2015 Valuation	As of FY 2020 Valuation	As of FY 2025 Valuation	As of FY 2030 Valuation	As of FY 2035 Valuation	As of FY 2040 Valuation
1	**Funding Goal** (based on a 30-year funding plan and hypothetical targets that would be adjusted after actuarial analysis of benefit and funding policy options outlined in previous tables were adopted)							
2	Target Amortization Period	does not amortize	70 yrs	45 yrs	30 yrs	20 yrs	10 yrs	no unfunded liabilities
3	Required Additional Funding (RAF)	not applicable	** (hypothetically 3%)	** (hypothetically 3.5%)	** (hypothetically 4.0%)	** (hypothetically 3.0%)	** (hypothetically 1.5%)	none
4	**Funding Sources** (does not include employee contributions because employee contributions can only be used to cover normal cost, not unfunded liabilities due to contract impairment issues)							
5	Employer contribution rate increase	not applicable	0% of salary	0.5% of salary	1.0% of salary	0.5% of salary	0.5% of salary	0.5% of salary
6	Supplemental General Fund	not applicable	0.5% of salary	0.5% of salary	0.5% of salary	0.5% of salary	0% of salary	0% of salary
7	Other source A	not applicable	1.0% of salary	1.0% of salary	1.0% of salary	1.0% of salary	0.5% of salary	0% of salary
8	Other source B	not applicable	1.5% of salary	1.5% of salary	1.5% of salary	1.0% of salary	0.5% of salary	0% of salary

	TRS	As of FY 2011 Valuation	As of FY 2015 Valuation	As of FY 2020 Valuation	As of FY 2025 Valuation	As of FY 2030 Valuation	As of FY 2035 Valuation	As of FY 2040 Valuation
9	**Funding Goal** (based on a 30-year funding plan and hypothetical targets that would be adjusted after actuarial analysis of benefit and funding policy options outlined in previous tables were adopted)							
10	Amortization goal	71 yrs	65 yrs	45 yrs	30 yrs	20 yrs	10 yrs	no unfunded liabilities
11	Required Additional Funding (RAF)	not applicable	** (hypothetically 1%)	** (hypothetically 2.0%)	** (hypothetically 3.0%)	** (hypothetically 2.5%)	** (hypothetically 2.0%)	none
12	**Funding Sources** (does not include employee contributions because employee contributions can only be used to cover normal cost, not unfunded liabilities due to contract impairment issues)							
13	Employer contribution rate increase	not applicable	0% of salary	0.5% of salary	1% of salary	1.5% of salary	1% of salary	0.5% of salary
14	Supplemental General Fund	not applicable	0% of salary	0.5% of salary	1.5% of salary	1.0% of salary	1% of salary	0% of salary
15	Other source A	not applicable	0.5% of salary	0.5% of salary	0.5% of salary	0% of salary	0% of salary	0% of salary
16	Other source B	not applicable	0.5% of salary	0% of salary	0% of salary	0% of salary	0% of salary	0% of salary

APPENDIX C
Principles and Guidelines for Public Employee Retirement Systems

As adopted by the State Administration and Veterans' Affairs Interim Committee
January 27, 2012

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.

Guidelines

A. The legislature should approve all changes of benefits.
B. The legislature should approve the funding of the state's retirement systems.
C. The legislature should regularly review the management of the state's public retirement systems and the investment of the systems' assets.
D. The legislature should maintain permanent, pension-review bodies to analyze the problems of the state's public retirement systems on an ongoing basis and to make recommendations for state legislative actions.
E. The legislature should require contemporaneous funding of pension benefits to ensure that pension costs are not shifted to future taxpayers, including that any increase in pension benefits be accompanied by a corresponding and equal increase in employer and employee contributions.
F. The legislature should require a fiscal note when establishing or amending pension plan benefit provisions and the fiscal note should state whether the proposed revisions follow the principles and guidelines established under 5-5-228, MCA.
G. The legislature should ensure that the full, long-term costs of early retirement programs and incentives have been calculated before such a program is adopted in order to allow the legislature to provide for the costs.
H. The legislature should ensure that post-retirement benefit adjustments are independently funded and have a ceiling on the percentage of increase for a single year.
I. The legislature should provide strict guidelines for disability coverage and should provide for periodic, follow-up screenings of disabled retirees.
J. The legislature should make available but not pay for health insurance for retired employees. Health insurance is not a benefit available through the retirement systems administered by the Public Employees' Retirement Board or the Teachers' Retirement Board.
K. The legislature should establish strict fiduciary standards and conflict of interest laws to govern the conduct of trustees as they manage the assets of the retirement system.
L. The legislature should continue to require annual actuarial reports that use

uniform actuarial assumptions to evaluate the financial soundness of the state's public retirement systems.

M. The legislature should provide for reciprocity of benefits for workers who shift jobs within the state and its political subdivisions and portability for those who shift jobs across state lines.

N. The legislature should ensure that pension plan participants are fully informed of plan provisions, including benefits, service and vesting requirements, assets and liabilities, investment performance and risk, actuarial assumptions and data, fiduciary requirements, and selection of plan trustees.

O. The legislature should support coordination of state and local government retirement systems.

P. The legislature should encourage and support the efforts of state retirement system administrators to comply with the principles of pension system administration established by the Public Pension Coordinating Council.

Q. The legislature should not index postretirement benefit increases.

R. The legislature should not enact one-time, *ad hoc* benefit increases.

S. The legislature should require that public employees belong to a retirement plan.

T. The legislature should continue to authorize local governments to enroll rural firefighters under the Firefighters' Unified Retirement System, provided the local government pays the cost.

U. The legislature should strive to ensure that retirement benefit formulas in the public safety retirement plans are similar.

V. The legislature should resist changes to retirement benefit formulas or retirement eligibility criteria that would encourage early retirement.

W. The legislature should encourage retirees who return to work to also return to active retirement plan membership.

X. The legislature should require an independent review of the return on investment every 5 years.