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TO: Members of the State Administration and Veterans' Affairs Interim Committee
FROM: Dave Bohyer
RE: Issues and Options Checklist

I have attached a document that the Committee can use as a tool to discuss the issues identified in HJR 42 or through the Committee's examination this interim of the state's public employee retirement systems. The options identified in the document are not exhaustive but may serve to provoke further discussion among the members.

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STATE ADMINISTRATION/VETERANS' AFFAIRS
OCTOBER 6, 2005 MEETING

EXHIBIT 8

Issues and Options Checklist
HJR 42: Public Employee Retirement Systems

Issue

The legislature is charged by the Montana Constitution with maintaining each of the public employee retirement systems in an actuarially sound manner. However, the actuarial soundness of four of the systems -- PERS, GWPORS, SRS, and TRS -- does not meet standards established for the State's plans, specifically, none of the four systems is able to amortize its actuarial unfunded liability in 30 years or less.

The manner in which the systems came to their current status may be attributable to numerous factors that one observer[1] characterized as "a perfect storm", thus:

- The Legislature increases benefits
- Benefits cannot be decreased
- Capital markets decrease asset bases
- Asset bases cannot be increased
- Markets are beyond legislative control
- Markets are unpredictable and volatile
- Investment returns cannot "fix" the problem

Examination

The Legislature Increases Benefits: Factually, the Legislature has increased benefits from time to time. In recent years, for example, the Legislature granted a guaranteed annual benefit adjustment (GABA) to members of each of the four systems at issue.[2] However, the Legislature granted to members of the JRS, HPORS, MPORS and FURS the same benefit enhancements at the same time that the benefits were increased for members of the PERS, GWPORS, and SRS and they -- JRS, HPORS, MPORS and FURS -- each remain actuarially sound . Additionally, the fiscal notes prepared for the enhancement bills stated that, "the increased cost for each retirement system will be

[1] Testimony of Carroll South, Executive Director, Montana Board of Investments, before the State Administration and Veterans' Affairs Interim Committee, September 9, 2005.

[2] See HB 294, 57th Legislative Session and HB 72, 56th Legislative Session.

absorbed by the respective system"[3] or were paid for by an increase in the retirement contribution paid by the employer (state) and the employee (teacher).[4] Therefore, the record indicates that the most significant benefit increases enacted by the Legislature are not the sole perhaps not even a primary factor in the systems' actuarial unsoundness.

Options

Increase Interim Legislative Scrutiny of Retirement Legislation: The Committee may wish to recommend reinstating the practice of scrutinizing retirement-related legislation through a pre-session vetting process to ensure that the substance of the legislation does not compromise any of the retirement plans. Alternatively, a new process of interim legislative oversight could be developed. The Committee could recommend that statutes be revised or adopted to *require* greater interaction between, e.g., the relevant boards or the relevant boards and the Committee.

Increase Legislative Scrutiny of Retirement Legislation During Sessions: The Committee may wish to recommend establishing, e.g., a standing committee on public retirement systems that would be charged with weighing the relative merits of each retirement-related bill in the context of maintaining healthy retirement systems and achieving other objectives. The Committee could recommend that the members of State Administration standing committees be better educated and trained in the subject of public pensions *prior* to session. The Committee could consider recommending that an actuarial review or analysis of each retirement-related bill be performed prior to passage from the committee, e.g,, by its own staff or by contracting with consulting actuaries.

Examination

Benefits Cannot Be Decreased: Retirement benefits cannot be decreased to current system members unilaterally by the employer due to impairment of contract considerations.

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[3] See Fiscal Note to HB 294, 57th Legislative Session.

[4] See Fiscal Note to HB 72, 56th Legislative Session.

Options

Design a New System for Prospective Employees: The Committee could recommend an alternative retirement system or systems for prospective employees, e.g., a defined contribution plan or a cash purchase option.

Examination

Capital Markets Decrease Asset Bases: It is true that capital markets decrease asset bases, but it is equally true that capital market also increase asset bases. Truth be told, it is the very fact that capital markets increase asset bases that allows pension systems to function at all and the same can be said for any type of an investment that provides an annuity.

The effect observed as a result of the "perfect storm" shows that the capital markets did decrease the asset base during a 2- or 3-year time span. However, the time horizon for pension systems is decades long at least and it is likely that capital markets, over the long term, will return to and generate the historical rate of return.

Options

Scrutinize Prior Investments: The Committee could more closely examine the investment transactions to which the unexpectedly-low investment returns and actual investment losses might be attributed to satisfy the members' curiosity about what events took place. While there is no way to turn back the clock to avoid losses that occurred in the past, a deeper investigation may lead to findings and conclusions that could forestall similar losses in the future or that could enhance the performance of the systems' portfolio.

Examination

Asset Bases Cannot Be Increased: Asset bases can be and are increased whenever, for example, the actual return on the asset bases exceeds the actuarially assumed rate of return. An asset base can also be increased by an infusion of money, either on an ongoing basis or from a one-time source.

Options

One-time Contribution: The Committee could recommend that "one-time" money be contributed to the asset base of any of actuarially deficient systems.

Planned Periodic Contributions: The Committee could recommend that money be contributed periodically to the asset base of any of the actuarially deficient systems. For example, a fixed dollar amount or a fixed percentage amount of any excess fund balance could be dedicated to paying down the actuarial unfunded liabilities. This would be similar to a home buyer making one additional payment each year to reduce the outstanding mortgage principle, thereby reducing the period over which the mortgage would otherwise be paid off.

<u>Examination</u>

Markets Are Beyond Legislative Control: It is true that financial markets are beyond legislative control.

<u>Options</u>

None.

<u>Examination</u>

Markets Are Unpredictable and Volatile: Financial markets are, over short periods of time at least, unpredictable and volatile, but each of those characteristics can work to the benefit of an investor (pension system) as easily as they can work to the investor's detriment. Over long periods of time, decades for example, financial markets have proved to be relatively predictable and stable.

<u>Options</u>

Avoid Over-reacting: It is a principle of sound investing that investors should not overreact to short-term volatility or unpredictability. "Do nothing different" is an option, albeit an option with corresponding risks and may be the most prudent option when all principles of investing and the state's objectives are considered jointly.

<u>Examination</u>

Investment Returns Cannot "Fix" the Problem: In the short run, it is almost certainly true that investment returns will not be high enough to reinstate the actuarial integrity of the four systems. It is not nearly as clear that, over a longer time-horizon, investment returns cannot resolve a substantial portion of the problem. Investment objectives, including the fundamental soundness of retirement systems, are typically achieved over long periods of time, e.g., 30 years or more, and it is more likely than not that investment returns will return to the long-term norm over the long term.

Options

Avoid Over-reacting: The Committee could recommend to the Board of Investments to "Do nothing different" as an option, recognizing of course that it is an option with corresponding risks.

Half a Loaf: The Committee could recommend an increase in predictable revenue, i.e., employer contributions, to address as large a portion of the unfunded liability as is considered advisable, practical, necessary, etc.

Summary of Options

- *Increase Interim Legislative Scrutiny of Retirement Legislation*
  - Presession vetting process
  - New processes for legislative oversight
  - Statutorily require more board/committee interaction
- *Increase Legislative Scrutiny of Retirement Legislation During Sessions*
  - Create a new standing committee for retirement legislation
  - Educate members of standing committees prior to session
  - Institute a formalized actuarial review of retirement legislation
    - ✓ Legislative staff
    - ✓ Consulting actuaries
- *Design a New System for Prospective Employees*
  - Defined contribution system
  - Cash purchase option
  - Numerous other options
- *Scrutinize Prior Investments*
  - Examine investment transactions that resulted in below-assumption ROI
- *One-time Contribution*
- *Planned Periodic Contributions*
  - Fixed amount
  - Fixed percentage of excess fund balance
- *Avoid Over-reacting*
  - Recommend "stay the course"
- *Half a Loaf*
  - Increase employer contribution
    - ✓ Phase-in/phase-out new rates
    - ✓ Enact new rates to be changed when/if appropriate

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