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RESEARCH MEMORANDUM

TO: Senator Dave Lewis

FROM: Sheri Scurr, Research Analyst
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RE: Information Request No. 3736
Historical review of setting investment rate of return assumption for public employee retirement system actuarial valuations

PART I - INTRODUCTION

This memorandum is in response to your November 4, 2013, request for historical research about the responsibility for setting the investment rate of return (ROI) assumption for actuarial valuations of the public employee retirement systems. Specifically, you wanted to know whether there were any public policy discussions about having the Board of Investments set the ROI at the time the Board of Investments was created, before or during the 1972 Constitutional Convention, or when Article VIII, Section 13, of the Montana Constitution concerning "actuarial determinations" was enacted. You also requested information about what entities in other states are responsible for setting the ROI assumption for actuarial valuations.

Methodology

To research discussions, staff reviewed the minutes of: (1) the 1972 Constitutional Convention; (2) the 1993 Legislative Session concerning the legislation that became C-25, the constitutional referendum enacting Article VIII, Section 13 of the Montana Constitution; (3) the Teachers' Retirement Board (TRB) meetings from 1970 through 1973; and (4) the Public Employee Retirement Board (PERB) meetings from 1970 through 1973.

Staff was not able to review the minutes from the Board of Investment meetings from 1970 through 1973. These minutes are archived with the Montana Historical Society. However, their building is under renovation and its archives have been put into deep storage. Staff will not be able to access those Board of Investment minutes until this renovation is complete. The target date for completion is April 15, 2014.

In researching other states, staff collected information available from the National Association of State Retirement Administrators.

Summary of findings

Staff did not find any evidence of specific discussion about whether the Board of Investments or the retirement boards should be responsible for establishing the ROI assumption for actuarial valuations of the retirement systems. Also, there is no state in which the investment manager for the public pension funds sets the ROI assumption. However, some of the information collected may be useful and so is reviewed below.

PART II - SPECIFIC FINDINGS

What do other states do?

According to the National Association of State Retirement Administrators, in 31 states, the state retirement boards also invest the public pension funds and are responsible for setting the actuarial ROI assumption. The other 19 states are similar to Montana in that a separate entity manages the pension fund investments.¹ In 17 of these 19 states, the retirement board, not the investment manager, sets the actuarial ROI assumption. In the other two states (Minnesota and Washington), the ROI assumption is set by statute.

1971 - Board of Investments created

The Board of Investments was created in statute by SB 274, passed during the 1971 Legislative Session (the 42nd Legislature). This bill was an Executive Branch reorganization bill to implement a 1969 amendment to the Montana Constitution, which was passed during a 1969 Special Legislative Session. The constitutional amendment required that all executive offices, agencies, and boards, etc., be allocated by law among not more than 20 departments. One of the stated purposes of the bill was to eliminate "duplication of effort". Under the bill, the retirement boards were attached to the Department of Administration for administrative purposes only and the Board of Investments was created to handle all investment functions for all state agencies, including for the TRB and PERB. The bill did not mention duties related to setting actuarial assumptions for actuarial valuations of the retirement systems. Any records from the 1969 Special Session or the 1971 Regular Session that may be in the Historical Society archives are inaccessible to staff until the Historical Society renovation is completed sometime in April 2014.

1972 - New Constitution

In 1972, delegates at the Constitutional Convention decided to replace an outdated article from the 1889 Constitution, Article XXI, which was passed as a constitutional amendment in 1924.² Article XXI created three permanent revenue funds that – except for the public school fund – were not used, primarily because the funds required extremely high principals before any interest could be distributed.³ Article XXI specified that funds were to be invested in a common fund called the “Montana Trust and Legacy Fund” and that “the same state board and officers that have charge of the investment and administration of the public school fund of the state shall have charge of the investment and administration of all the funds administered under this article”.⁴ The provisions of the article dealing with the public investment of funds were replaced by Article VIII, section 13, in the 1972 Constitution. This article instructed the Legislature to

¹ Delaware, Florida, Illinois, Iowa, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oregon, South Carolina, South Dakota, Tennessee, Vermont, Washington, West Virginia, and Wisconsin.

² *Montana Constitutional Convention, Verbatim Transcripts*, Vol. II, p. 583.

³ Constitution of Montana, 1889, Article XXI.

⁴ Constitution of Montana, 1889, Article XXI, section 5.

“provide for a unified investment program for public funds and provide rules therefor”.⁵ The Constitutional Convention Revenue and Finance Committee noted that “the regulation and limitation of the investment program, and the administrative structure of the investment program, is left up to the legislative assembly”.⁶ The committee further noted that “[t]he legislature is best equipped to make decisions concerning investment opportunities for state money.”⁷ A minority on the Revenue and Finance Committee noted with concern that testimony had placed emphasis on the return on investment rather than security.⁸ The minority proposed an additional sentence to prohibit public funds from being invested in private corporate capital stock, except for money contributed by individuals to retirement funds. This, they contended, would support their position of prioritizing goals in the following order: security, investment in Montana, and the return on investment.⁹ Delegate Artz also pointed out that the committee had been pressured to allow the Legislature to invest in private stocks, and a constitutional provision would relieve any subsequent pressure on legislators to allow private investment.¹⁰ In addition, delegates pointed out the difficulty of a state voting capital stock, especially if the business’ interests were contrary to state policies.¹¹ Delegate Heliker objected to this addition, noting that the Legislature should have the discretion to provide a unified investment program as it saw fit, including the investment of retirement funds in stocks with greater returns, especially in light of depreciation.¹² He further noted that the Legislature would not be making investment decisions, rather “[i]t will turn the job over to experts.”¹³ Nevertheless, the minority proposal was passed by the convention; however, there was no specific discussion during the convention of who would make investment assumptions for the purposes of retirement systems.

1970-1973 Teachers' Retirement Board discussions

May 16, 1970 Excerpt of minutes: "The Board next considered the setting of the interest rate on the annuity savings funds for 1970-71. The Secretary reported the interest earnings on total book value of assets for 1968-69 were 5.22 percent and that for 1969-70, it should be at least 5.37 percent. Mr. Burke moved the adoption of Resolution No. 53, which would set the interests rate for 1970-71 at 5.25 percent. Mr. Hayes seconded the motion which was approved." Attached to the minutes is Resolution No. 55, which formalizes this motion and also instructs the actuary to use an assumption of 4% to determine the "amounts of the reserves".

March 1, 1971 Board members discussed the results of a 5-year experience study. The minutes note that the higher yields the Board was now realizing on

⁵ Constitution of Montana, 1972, Article VIII, section 13.

⁶ *Montana Constitutional Convention, Verbatim Transcripts*, Vol. II, p. 597.

⁷ *Id.*

⁸ *Id.* at Vol. II, pp. 602-603

⁹ *Id.* at Vol. V, p. 1519.

¹⁰ *Id.*

¹¹ *Id.* at Vol. V, pp. 1519, 1521.

¹² *Id.* at Vol. V, p. 1525

¹³ *Id.* at Vol. V, p. 1526.

investments was not reflected in the study. The minutes also note that the actuary suggested that the Board formally adopt the 1951 4% Group Annuity Table, which was already being used by the actuary. The Board also discussed implementation of the Governor's reorganization bill, SB 274. The Executive Secretary report states: "We will continue as a board, which will set policyWith passage of SB 274, we no longer have any investment functions. A new department is to be set up within the Department of Administration to do the investing for the state."

- July 15, 1971 Board members were introduced to Mr. James Howeth, the new State Investment Officer. A Board member asked if investment procedures would remain the same as in the past. According to the minutes, Mr. Howeth replied that although investing would be done through his office, he would welcome and consider any recommendations from the Board.
- September 17, 1971 The Board's Executive Secretary, Alton Hendrickson, noted that the retirement system had not had a full actuarial valuation in recent years, and he suggested the Board could either contract with an outside actuary or have him [Alton] conduct the valuation because he was also a qualified actuary. He said he would set up a computer program to conduct the valuation, which would determine: (1) the current funding position of the system, (2) the funding progress that can be anticipated in future years, and (3) the projected cost of any proposed benefit improvements. He noted that actuarial assumptions are determined by reviewing past and anticipating future experience. The Board decided to further consider this at the next meeting.
- November 12, 1971 The Board approved what was called a "13th check" for members who had retired since July 1, 1971. The amount of the check was to be for the difference between the 1970-1971 5.5% interest rate for the annuity savings accounts and the 3% ROI assumption.
- June 24, 1972 The Executive Secretary for the TRB, Alton Hendrickson, reported to the Board about a national conference and workshop he had attended. The minutes state: "I was encouraged to find that the actuarial assumptions used by other actuaries valuing state plans were comparable to those used in the recent actuarial valuation of our system." He continued to discuss the trend related to increasing the amount of pension funds that could be invested in stocks and noted: "Because of the new constitution, the system can now invest in stocks provided the legislation is approved. Although the retirement board no longer has the authority to invest the system's assets, I hope that it will recommend that the investment board support such legislation."
- August 25, 1972 There was some discussion about the policy of the Board of Investments to keep only a minimum of pension fund assets in cash. The TRB had concern that this policy would not provide the Teachers'

Retirement System (TRS) with enough cash on hand to pay TRS members who wished to withdraw their contributions upon termination. The minutes indicate that "the investment board had been instructed to retain a sizable amount in liquid assets".

- October 6, 1972 The Executive Secretary reported about a national conference and said in summary that: "One of the workshops dealt with reflecting investment return in the actuarial assumption. The interest assumptions currently being used in the actuarial valuations [in other states] range from 4% to 6 1/2%. The average rate was about 5 1/2%, which is currently the rate assumed by this system."
- March 30, 1973 The TRB members discussed the reports that TRB regularly received from the Board of Investments and passed a motion to request that the TRB's Executive Secretary secure copies of investment policies from the Board of Investments and continue to be updated on any changes with respect to whether the Board of Investments was seriously considering investing in stocks.
- August 9, 1973 The TRB members discussed guidelines by the Board of Investments that included an initial list of 30 stocks that the Board of Investments had approved for potential investment by the investment officer. The guidelines stated that the Board of Investments' goal was to have no more than 5% of any retirement fund invested in stocks.
- October 26, 1972 The TRB Executive Secretary reported that the yield [i.e., ROI] for the fiscal year ending June 30, 1973, was 6.31% and that after deducting administrative expenses, the true earnings rate was about 6.25%. After some discussion, the TRB voted to establish 6.25% as the ROI assumption for the FY1973 actuarial valuation of TRS.
- December 14, 1973 The actuarial valuation results for FY1973 showed that the amortization period for unfunded liabilities had been reduced from 68.4 years for FY1971 to 41 years and that the primary reason for the change was the change in the ROI assumption from 5.5% for the FY1971 valuation to 6.25% for the FY1973 valuation.

1970-1971 Public Employees' Retirement Board discussions

- January 16, 1970 Board members noted that the actual yield on investments for FY1968-69 was 5.04% compared to 4.558% for FY1967-68. Investments consisted of bonds and real estate, and the 5.04% yield included the downturn in the U.S. Government bond market.
- February 20, 1970 The Board's consulting actuary, Mr. Thomas P. Bleakney, discussed his work toward completing an actuarial valuation for the previous fiscal year and noted his support for the concept being floated for legislation to allow pension funds to be invested in stocks because it would increase the return on investments, which would help fund the retirement system. He noted that employee and employer contributions remained inadequate to soundly fund the benefits provided by the system and that the contributions had been inadequate since the system was established.
- December 18, 1970 The minutes summarize a letter from the Board's consulting actuary, Mr. Bleakney, as follows: "Mr. Bleakney was disturbed that no common method [among the states] has been established for measuring investment yields of public employee retirement systems. He noted further that he tended generally to put very little weight upon the information as to yield given in the reports and surveys of the National Association of State Retirement Administrators for the above reasons [the lack of a common methodology]." The minutes go on to state that Mr. Bleakney had studied investment yields from statistics available from the U.S. Census Bureau and determined that PERS ranked 70th in its investment yields when compared to 590 other public retirement systems and that "would rank PERS in the upper 10% by yield". Mr. Bleakney characterized this as "outstanding". The Board next discussed the Executive Reorganization Plan (which would later become SB 274, which established the Board of Investments). There was discussion in support of having the retirement funds invested by the Board of Investments and discussion in opposition. There was also discussion about the idea of having a PERB member on the Board of Investments. The Board's final action was to recommend the retention of a retirement board and periodic review of investment policy by a Board member. The minutes also note that the consulting actuary, Mr. Bleakney, had been contacted about providing cost estimates for retirement legislation during the upcoming 1971 legislative session. The minutes do not reflect any discussion about actuarial assumptions or the ROI assumption.

- January 8, 1971 The Board received the actuarial report from the Board's consulting actuary, Mr. Bleankney, which the Board had requested to project the cost of various retirement plan proposals under consideration by the Legislature. According to the report, the cost estimates for the legislation were based on an ROI assumption of 5.5% and a 40-year amortization schedule. The Board discussed the term "actuarial soundness". Mr. Bleakney explained that it meant the system was meeting its current liabilities and funding it's contingent liabilities over 40 years, which he reported was the most commonly accepted funding period.
- March 31, 1971 The Board received presentations about the bond market and examined "holes" in the maturity dates of its portfolio. Based on presentations from its investment advisors, D.A. Davidson, Piper, Jaffray and Hopwood, Inc., and J.M. Dain and Company, the Board decided to authorize the immediate sale of certain low-yielding government securities and reallocate the funds to investments in higher-yielding corporate bonds.
- May 14, 1971 The Board received a presentation from the State Controller on the Executive Reorganization and the functions of the Board of Investments. There was no discussion noted about transferring duties related to actuarial determinations or setting the ROI assumption.
- July 16, 1971 The Board received a presentation from the State Investment Director, Mr. Howeth, and discussed the functions of the Board of Investments (BOI). It was noted that it would no longer be necessary to continue the historic practices of having the PERB meet on each investment of funds. Instead, investment decisions would be made by investment officers within the broad guidelines established by the BOI. A PERB Board member asked if the BOI staff would provide reports to the PERB to allow the PERB to evaluate the performance of the BOI. The PERB member also questioned whether the BOI would invest in offerings through local Montana investment firms. Mr. Howeth responded that the new law did not require that he "subsidize local investment firms", but that the department would secure the best price available on each offering regardless of the location of the investment firm. The actuarial report to the PERB by Mr. Bleakney, the consulting actuary, showed that he recommended a 4.69% increase in employer contributions to maintain the system on an actuarially sound basis and amortize unfunded liabilities within 40 years. The report noted that the employer contribution rate was increased [by the Legislature], but not to that full amount. The cumulative effect of this and other provisions and unspecified assumptions was that the amortization period would be 55 years.

December 17, 1972 The Investment Officer for the Board of Investments asked for the PERB comments on how the pension funds should be invested under the new constitution. The PERB discussed: (1) a 10% stock limitation, (2) a variable annuity approach, and (3) postponement of any legislation specifying investment parameters. The PERB voted to postpone requesting any legislation concerning investments. The PERB next considered the makeup of the Board of Investments and voted to recommend that one member from the PERB and one member from the TRS Board be on the Board of Investments.

1994 - Constitutional Referendum C-25

Article VIII, section 15, of the Montana Constitution concerning public retirement system assets was initially a legislatively referred constitutional amendment during the 53rd session of the Legislature in 1993. The proposed constitutional amendment, SB 90, was sponsored by Senator Judy Jacobsen (D-Butte) and cosponsored by Senator Bob Brown (R-Whitefish). The PERB was involved in the drafting of the bill's language.¹⁴ The referendum included a requirement that the investment of public retirement system assets would be managed in a fiduciary capacity¹⁵ and a new section that required the retirement systems to be funded "on an actuarially sound basis" and required the retirement boards to administer the systems "including actuarial determinations,"¹⁶ as fiduciaries of the systems.

During hearings on SB 90, most testimony revolved around the practice of other states raiding pension funds and the idea that funds collected for pension purposes should be reserved for administering the pension systems. In written testimony, the Montana Public Employee Pension Security Coalition (PEPSCo) noted that the legislation would require the governing pension boards to act in a fiscally responsible manner on behalf of pension members and beneficiaries. In addition, Tom Bilodeau, testifying on behalf of PEPSCo, noted that establishing fiduciary responsibility for the retirement boards would constrain both internal raids of the pension funds "as well as political or economic manipulation of actuarial assumptions".¹⁷ He also noted that the Board of Investments had reviewed the legislation and that the Board of Investments would retain day-to-day investment responsibility.¹⁸ In addition, the Senate received an exhibit showing that in the preceding 2 years, 10 states had considered proposals to change actuarial assumptions or the assumed investment rate of return, among other considerations.¹⁹ PEPSCo included the Montana Education Association, Association of Montana Retired Public Employees, Montana Public Employees Association, Montana Retired Teachers and School Personnel Association, Montana Federation of Teachers and State Employees, and American Federation of State, County, and Municipal Employees. Other

¹⁴ Testimony of Mark Cress, State Administration Hearing, Montana House of Representatives, January 26, 1993.

¹⁵ Constitution of Montana, 1972, Article VIII, section 13.

¹⁶ *Id.* at section 15.

¹⁷ Testimony of Tom Bilodeau, State Administration Hearing, Montana House of Representatives, January 26, 1993.

¹⁸ *Id.*

¹⁹ Exhibit 2. State Administration Hearing, Montana Senate, January 18, 1993.

proponents included the Montana Sheriffs and Peace Officers Association, Montana State AFL-CIO, Butte Retired Teachers' Association, the PERB, and the TRB.²⁰ No opponents testified, and the bill passed the Senate unanimously. In the House, the bill passed with only six votes and three votes opposing the bill on second and third reading, respectively.

The Protection of Public Pension Assets Amendment (C-25) appeared on the November 8, 1994, ballot.²¹ The advocates for C-25 stated that it was supported by Governor Racicot, among others.²² The opponents' argument in the voter information pamphlet noted that a constitutional amendment was not needed to protect pension funds and that the passage of the measure could send a message to investors that the state was worried about its fiscal condition.²³ In the aftermath of the 1994 general election, the Associated Press noted that C-25 was "fueled by public employees' fear that their pension funds would be tapped to help finance government", and it was one of four ballot issues that "saw little public debate during the campaign season".²⁴ C-25 passed with 243,855 (73%) voting for the amendment and 88,336 (27%) voting against the amendment.²⁵

PART III - CONCLUSION

The records reviewed do not reveal any discussion or controversy about whether the Board of Investments or the TRB and PERB should set the actuarial ROI assumption. Rather, the record shows that even after the creation of the Board of Investments, the assumption continued to be set as part of the actuarial valuations done for the TRB and PERB.

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²⁰ Senate State Administration Hearing, January 15, 1993; House State Administration Hearing, January 26, 1993.

²¹ Amendments to the 1972 Montana Constitution. Secretary of State.
<http://sos.mt.gov/Elections/forms/history/constitutionalmeasureslist2010.pdf>

²² Voter Information Pamphlet, 1994. Secretary of State.
http://sos.mt.gov/Elections/Archives/1990s/1994/1994_VIP.pdf

²³ *Id.*

²⁴ Associated Press, "Yes to Contribution Cap," Helena Independent. Nov. 9, 1994.

²⁵ Amendments to the 1972 Montana Constitution. Secretary of State.
<http://sos.mt.gov/Elections/forms/history/constitutionalmeasureslist2010.pdf>