



Legislative Research Brief

for the
State Administrative and Veterans' Affairs Interim Committee

February 6, 2014

What is the Plan Choice Rate and Why Was it Established?

A Component of the Public Employees' Retirement System Defined Contribution Plan

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What is the plan choice rate?

The plan choice rate (PCR) is an amount paid by employers of PERS-DC plan members to the PERS-DB plan trust fund. The PCR was designed to pay off the Unfunded Actuarial Liability (UAL) and any normal cost (NC) change associated with allowing PERS members to opt out of the PERS-DB plan and select the PERS-DC plan. The PCR is calculated as a percentage of salary paid to PERS-DC plan members. This percentage is set by statute in section 19-3-2117, Montana Code Annotated (MCA), and is subject to adjustment by the Public Employees' Retirement Board (PERB) according to a formula prescribed under section 19-3-2117, MCA.¹ These statutes, combined with the employee's contribution, essentially provide for the following allocation of contributions to the PERS-DC plan member accounts:

8.17% - employer contribution to the PERS-DC plan or ORP
 minus 2.37% - PCR paid to DB plan trust fund
 minus 0.27% - temporary supplemental PCR paid to DB plan trust fund²
 minus 0.04% - paid to education fund
 minus 0.30% - paid to disability fund
 minus 1.00% - temporary amt. paid to DB plan unfunded liabilities³
4.19% - remaining employer contribution

7.90% - employee contribution to the PERS-DC plan or ORP member accounts
+4.19% - remaining employer contribution
12.09% - total contribution allocated to PERS-DC plan or ORP member accounts

¹ See statutes provided at Attachment A.

² See section later in this paper that discussed triggers that terminate certain contributions.

³ HB 454 from the 2013 session temporarily increased employer contributions in PERS. Section 19-3-2117, MCA, was amended to provide that the 1% employer contribution increase under the PERS-DC plan would be allocated to the PERS-DB plan unfunded liabilities.

The plan choice rate currently totals 2.64% of PERS-DC plan member compensation. Translated to a dollar amount based on annualized payroll data provided for the June 30, 2013, actuarial valuation, this is about \$ 2,809,470. Based on the valuation, the current 2.64% PCR would completely amortize the UAL and NC determined to be the cost of providing the DC plan option in PERS in 3.2 years. The total amount to be paid off in 3.2 years is about \$ 8,749,140.

The remainder of this briefing paper discusses the legislative history of why and how the PCR was established.

House Bill No. 90

In 1997, the Montana Legislature passed House Bill No. 90, which was requested by the interim Committee on Public Employee Retirement Systems (CPERS).⁴ The bill required that an interim committee designated by the Legislative Council design a retirement plan to replace or modify the Public Employees' Retirement System (PERS) in order to provide for a defined contribution (DC) retirement plan component to PERS. The bill also required the establishment of an implementation schedule that would, among other things, include provisions addressing how the costs of converting to the new or modified plan would be paid.

The Legislative Council tasked CPERS with this challenge. CPERS hired a consulting firm called Actuarial Sciences Associates (ASA) through a competitive process to assist in analyzing plan design and funding options.

Decision for an optional DC plan

After holding a series of focus groups with employers and employees across the state, holding three statewide public hearings involving 19 video conference sites, examining three comprehensive reports from ASA's consulting team, and debating several options, CPERS voted to recommend an optional DC plan for members of PERS.⁵

University System PERS members

During the focus groups and public hearings, PERS members employed by the University System expressed their desire to have the option of choosing the U-System's DC plan rather than the PERS-DC plan. Known then as the Optional Retirement Program (ORP), the U-System DC plan accessible only to faculty and administrators, not employees in generally classified positions who were covered by PERS. After considering this, CPERS decided to

⁴ Chapter 191, Laws of Montana, 1997.

⁵ Sheri Heffelfinger, "A Defined Contribution Retirement Plan: An Option for Members of the Public Employees' Retirement System", Montana Legislative Services Division, Committee on Public Employee Retirement Systems, December 1998.

extend to current and future employees in these U-System positions the opportunity to select either the new PERS-DC plan or the ORP.

Two types of cost

The ASA team explained to CPERS that the cost of providing an optional DC plan to current and future PERS members would be two-fold:

- there would be a cost associated with the PERS-DB plan's loss of future contributions and the investment earnings on those contributions that would otherwise be used to help fund the DB plan's unfunded actuarial liabilities (UAL); and
- there would be a cost associated with a potential increase in the normal cost of benefits in the DB plan as a result of "adverse selection" against the DB plan. In other words, younger employees would most likely choose the DC plan, thus increasing the average age and decreasing the expected working career of DB plan participants, which would result in increased costs for funding the DB plan's benefits.⁶

Two options for capturing these costs

Among the first issues CPERS had to grapple with was how to calculate these two types of cost. CPERS considered two basic options:

- account for costs by projecting the contribution level needed to fund the DB plan's UAL in 30 years assuming all of the PERS members had remained in the DB plan instead of selecting either the DC plan or the ORP;⁷ or

⁶ This summation is based on ASA's reports and testimony to CPERS during the 1997-1998 interim. Due to the remodeling of Historical Society storage facilities, staff has not been able to access records held in the archives that contain these documents from ASA. Therefore, this summary reflects staff's institutional memory based on personal working notes and files from the 1997-1998 study.

⁷ This method would be similar to the way the cost to TRS for the ORP was calculated. The ORP was initially an optional plan when it was established in 1983. However, controversy about how the cost to TRS was being determined led to a special actuarial study and a change in the actuarial method for setting the supplemental rate paid to TRS by the U-System. The ORP was made a mandatory plan in 1993. In 1997, legislation passed that codified the intent that the supplemental rate would fully pay the cost to TRS within 40 years from when the ORP was made mandatory in 1993. Thus, the 1997 legislation amended section 19-20-621, MCA, so that the supplemental contribution to the ORP would terminate July 1, 2033.

- account for these costs by doing the calculation described in the above bullet point, but also accounting for any normal cost changes in the DB plan as a result of "adverse selection"; then provide for a statutory formula so that actuarial projections of cost would be adjusted based on actual experience.⁸

Policy goals

To help CPERS determine which option to choose, ASA's consultants asked CPERS to articulate its main policy goals. The discussion among CPERS members revealed two goals:

- the PERS-DB plan's pension fund should not subsidize the cost of providing for the PERS-DC plan; and
- the PERS-DC plan should not subsidize unfunded liabilities or normal cost changes in the PERS-DB plan that were not actually attributable to the DC plan choice.

Policy decisions

Based on CPERS' articulated policy goals, ASA recommended the second option discussed above for approaching the costs to the PERS-DB plan of providing PERS member with the option to choose the DC plan; and CPERS adopted the recommendation. In taking that recommendation, CPERS agreed that:

- the supplemental contribution rate required to fund DC plan costs would be called the "plan choice rate";
- the baseline for the rate would be the contribution amount available to fund the PERS-DB plan's unfunded liabilities as of the 1998 actuarial valuation, which was 2.37%;
- any normal cost changes in the PERS-DB plan attributable to the PERS-DC plan would be determined each actuarial valuation by comparing the actual normal cost changes in the PERS-DB plan with what the normal cost in the PERS-DB plan would have been if the PERS members who actually selected the PERS-DC plan or ORP had remained in the PERS-DB plan;

⁸ See Footnote 6.

- the schedule for paying off the cost would be no more than 25 years⁹, but with a cushion of 10 years¹⁰ on either side of this target; and
- the PERS Board would be required to increase the plan choice rate if it was too low to pay off the liabilities in under 35 years (the 25-year target plus the 10-year cushion) or decrease the rate if it was too high and was paying off the liabilities faster than 15 years (the 25 years minus the 10-year cushion).

Who should pay the plan choice rate and how?

The next policy decision CPERS had to make was who should pay the plan choice rate and how would employee and employer contributions be allocated to DC plan member accounts. After considering options, CPERS chose to require that the costs be paid as part of PERS instead of funding it through a state general fund appropriation. Thus, it would be the PERS members who would pay the cost, keeping in mind the policy goals articulated previously. Also, CPERS wanted to keep the contributions to the PERS-DB and the PERS-DC plan equivalent.

Based on the 1998 PERS actuarial valuation, this policy decision translated to the following allocation of contributions:

	<u>DB plan</u>	<u>DC plan</u>
Employee contribution	6.9%	6.9%
<u>Employer contribution</u>	<u>6.9%</u>	<u>6.9%</u>
Total	13.8%	13.8%
Total available contributions	13.8%	13.8%
<u>Minus normal cost of benefits</u>	<u>-11.41%</u>	<u>N/A</u>
Amount available for UAL	2.37%	2.37% - plan choice rate (UAL/NC)
		6.90% - employer contribution
		- <u>2.37%</u> - plan choice rate to DB plan
		4.53% - to member account

⁹ The 25 years was used because the math worked out based on two considerations: (1) using the 1996 valuation, which was the latest available, the 2.37% of contributions available to fund the PERS-DB unfunded liabilities would fully amortize in 12.5 years; if multiplied by two (the number of years in each biennium), the product was 25 years; and (2) 25 years was a reasonable amortization schedule to allow a 5-year cushion under the 30 years commonly accepted as being maximum amortization period in an actuarially sound pension plan.

¹⁰ The 10 years was suggested by ASA to provide stability to the PCR given that investment return volatility for the PERS-DB plan could significantly swing an amortization schedule up or down.

Allocation to education and disability benefits

Some CPERS members were very concerned that PERS members receive education to help them understand their plan choices. Therefore, CPERS chose to allocate 0.04% of the employer contributions to an education fund for all PERS members.

Another issue of concern to CPERS members remained unresolved by the bill enacting the DC plan: how to provide PERS-DC plan members with disability coverage. Disability benefits are an integral part of the PERS-DB plan. A study bill passed by the 1999 Legislature resulted in the 1999-2000 State Administration and Veterans' Affairs Interim Committee studying various options and recommending that instead of funding disability insurance for DC plan members, a portion of the employer contribution to the PERS-DC plan would be allocated to a disability benefit pool in order to provide a defined disability benefit. This defined disability benefit was to be based on the same formula used to determine PERS-DB plan disability benefits (i.e., 1/56th x final average salary x years of service). The starting point for determining how much to allocate to the disability pool was set at the amount actuarially determined to represent the cost of providing disability benefits in the PERS-DB plan: 0.43%, which was adjusted downward to 0.30% after the 2000 actuarial valuation was completed.¹¹

Total allocation to DC member accounts in 2001

The legislation establishing the disability portion of the DC plan passed in 2001,¹² making the new allocation of contributions set in statute as follows:

6.90% - employee contribution to DC member accounts (PERS-DC or ORP)

6.90% - employer contribution to DC member account (PERS-DC or ORP)
- 2.37% - *plan choice rate to UAL/NC in PERS-DB*
- 0.04% - education fund
- 0.30% - *disability fund*
4.19% - employer contribution to DC member account (PERS-DC or ORP)

6.90% - employee contribution to DC account (PERS-DC or ORP)
+ 4.19% - employer contribution to DC account (PERS-DC or ORP)
11.09% - *total contribution to DC member account (PERS-DC or ORP)*

¹¹ For more information about the disability study see Sheri Heffelfinger, "Disability Benefits in the New Optional Defined Contribution Public Employees' Retirement System Plan", Montana Legislative Services Division, State Administration and Veterans' Affairs Interim Committee, Report to the 57th Legislature, November 2000.

¹² Chapter 423, Laws of Montana, 2001.

The PCR and disability contribution rate were made subject to adjustment by the PER Board based on an actuarial analysis under the statutory formula set out in section 19-3-2121, MCA. This was done, as previously mentioned, so that the PCR and the disability rate would be based on actual rather than projected experience.

A note about temporary contributions and triggers

Beginning with the first enactment of the Guaranteed Annual Benefit Adjustment (GABA) in PERS in 1998, the Legislature began adopting two types of mechanisms to try to control the impact of benefit and funding changes on employers and the state general fund:

- providing a state general fund supplemental contribution to offset increases in employer contributions; and
- providing triggers to terminate certain contribution increases based on the actuarial soundness of the PERS-DB plan.

These mechanisms not only affected contributions to the PERS-DB plan, but also affected contributions to the PERS-DC plan, including the PCR. As a result, statutory language concerning temporary supplemental contributions and the triggers for terminating these contributions has become quite complex. In fact, there are now two types of triggers at work in the PERS statutes: one based on an amortization schedule and one based on the funded ratio of the plan. Although the trigger based on the funded ratio is related to the GABA reduction in HB 454 from the 2013 Session and the GABA reduction has been enjoined by the court, the use of temporary contributions and triggers may be a topic for SAVA to review more carefully at some point during this interim.

Summary

The PCR developed through a series of deliberate policy choices made by the Legislature, guided by CPERS and SAVA. This policymaking process was aided by independent consultants working directly for CPERS when it developed the PERS-DC plan as required under HB 90 in the 1997 Session. This paper has described what the PCR is in terms of a percentage of compensation paid to PERS-DC plan participants (2.64%, of which 0.27% will terminate when a certain trigger is met) and in terms of the dollar amount that would be needed to pay off the PCR as of the June 30, 2013, actuarial valuation of PERS, \$8,749,140. This amount is paid from employer contributions to the PERS-DC plan and is projected to be paid of by the current PCR within 3.2 years. This paper has also provided the history of why the PCR was established, which was to fulfill two basic policy goals articulated by CPERS that:

- the PERS-DB plan's pension fund should not subsidize the cost of providing for the PERS-DC plan; and
- the PERS-DC plan should not subsidize unfunded liabilities or normal cost changes in the PERS-DB plan that were not actually attributable to the DC plan choice.

ATTACHMENT A
MONTANA CODE ANNOTATED 2013

Allocation of contributions in the PERS-DC plan

19-3-2117. Allocation of contributions and forfeitures. (1) The member contributions made under 19-3-315 and additional contributions paid by the member for the purchase of service must be allocated to the plan member's retirement account.

(2) Subject to subsection (3) and adjustment by the board as provided in 19-3-2121, of the employer contributions under 19-3-316 received:

(a) an amount equal to:

(i) 4.19% of compensation must be allocated to the member's retirement account;

(ii) 2.37% of compensation must be allocated to the defined benefit plan as the plan choice rate;

(iii) 0.04% of compensation must be allocated to the education fund as provided in 19-3-112(1)(b); and

(iv) 0.3% of compensation must be allocated to the long-term disability plan trust fund established pursuant to 19-3-2141;

(b) on July 1, 2009, continuing until the additional employer contributions terminate pursuant to 19-3-316(4)(b), the percentage specified in subsection (3) of this section of compensation must be allocated in the following order:

(i) to the defined benefit plan to eliminate the plan choice rate unfunded actuarial liability; and

(ii) to the long-term disability plan trust fund to provide disability benefits to eligible members; and

(c) on July 1, 2013, continuing until the additional employer contributions terminate pursuant to 19-3-316(4)(b), 1% of compensation must be allocated to the defined benefit plan unfunded liabilities.

(3) The percentage of compensation to be contributed under subsection (2)(b) is 0.27% for fiscal year 2014 and increases by 0.1% each fiscal year through fiscal year 2024. For fiscal years beginning after June 30, 2024, the percentage of compensation to be contributed under subsection (2)(b) is 1.27%.

(4) Forfeitures of employer contributions and investment income on the employer contributions may not be used to increase a member's retirement account. The board shall allocate the forfeitures under 19-3-2116 to meet the plan's administrative expenses, including startup expenses.

Adjustment of Plan Choice Rate and Disability Fund Contributions

19-3-2121. Determination and adjustment of plan choice rate and contribution allocations. (1) The board shall periodically review the sufficiency of the plan choice rate and shall adjust the allocation of contributions under 19-3-2117 as specified in this section. The board shall collect and maintain the data necessary to comply with this section.

(2) The plan choice rate set in 19-3-2117(2)(a)(ii) must be adjusted as provided in this section, taking into account:

(a) as determined under subsection (3), the change in the normal cost contribution rate in the defined benefit plan that is the result of member selection of the defined contribution plan; and

(b) as determined under subsection (4), the sufficiency of the plan choice rate to actuarially fund the defined contribution plan member's appropriate share of the defined benefit plan's unfunded liabilities.

(3) The change in the normal cost contribution rate must be an amount equal to the difference between the normal cost contribution rate in the defined benefit plan that would have resulted if all system members remained in the defined benefit plan and the normal cost contribution rate in the defined benefit plan for the actual members of the defined benefit plan, multiplied by the compensation paid to all of the members in the defined benefit plan, divided by the compensation paid to all of the members in the defined contribution plan. The measurements under this subsection must be based on the defined benefit plan in effect on the effective date of the defined contribution plan until the board determines that the defined benefit plan has been amended in a manner that significantly affects plan choices available to system members. After a board determination that the defined benefit plan has been significantly changed, the measurements in this subsection with respect to members entering the system after the significant change must be made on the basis of the defined benefit plan, as amended.

(4) The sufficiency of the plan choice rate to actuarially fund the appropriate share of the defined benefit plan's unfunded liabilities must be determined as follows:

(a) The board shall determine the number of years required to actuarially fund the defined benefit plan's unfunded liabilities as of the June 30, 1998, actuarial valuation, which must be the initial schedule for the defined contribution plan to actuarially fund the plan's share of the unfunded liabilities. The board shall reduce the schedule by 1 year each biennium.

(b) During each subsequent actuarial valuation of the defined benefit plan conducted pursuant to 19-2-405, the board shall determine whether the plan choice rate minus the amount provided in subsection (2)(a) of this section is sufficient to pay the unfunded liability obligations within the schedule determined under subsection (4)(a) of this section. If the amount is insufficient to fund the liability over a period of 10 years longer than the scheduled period or is more than sufficient to fund the liability over a period of 10 years earlier than the scheduled period, the board shall determine to the nearest 0.1% the amount of the increase or decrease in the plan choice rate that is required to actuarially fund the liabilities according to the established schedule.

(5) If the board determines that the plan choice rate should be increased or decreased, the plan choice rate under 19-3-2117(2)(a)(ii) must be increased or decreased

accordingly. If the plan choice rate is increased, the allocation of employer contributions to member accounts under 19-3-2117(2)(a)(i) must be decreased by that amount. If the plan choice rate is decreased, the allocation of employer contributions to member accounts under 19-3-2117(2)(a)(i) must be increased by that amount.

(6) If the board determines that the contribution rate to the disability plan under 19-3-2117(2)(a)(iv) should be increased, the employer contribution to each member's account under 19-3-2117(2)(a)(i) must be decreased by that amount. If the board determines that the contribution rate to the disability plan under 19-3-2117(2)(a)(iv) should be decreased, the employer contribution to each member's account under 19-3-2117(2)(a)(i) must be increased by that amount.

(7) By November 1 of the year of a determination pursuant to this section that the allocation of employer contributions under 19-3-2117(2) must be changed, the board shall notify system members, participating employers, employee and employer organizations, the governor, and the legislature of its determination and of the changes required.

(8) Effective January 1 of the year after the regular legislative session that immediately follows a determination under this section, the plan choice rate and the allocation of contributions under 19-3-2117(2) must be adjusted according to the board's determination.

Employer contributions to the PERS-DC plan

19-3-316. Employer contribution rates. (1) Each employer shall contribute to the system. Except as provided in subsection (2), the employer shall pay as employer contributions 6.9% of the compensation paid to all of the employer's employees plus any additional contribution under subsection (3), except for those employees properly excluded from membership. Of employer contributions made under this subsection for both defined benefit plan and defined contribution plan members, a portion must be allocated for educational programs as provided in 19-3-112. Employer contributions for members under the defined contribution plan must be allocated as provided in 19-3-2117.

(2) Local government and school district employer contributions must be the total employer contribution rate provided in subsection (1) minus the state contribution rates under 19-3-319.

(3) (a) Subject to subsection (4), each employer shall contribute to the system an additional employer contribution equal to the percentage specified in subsection (3)(b) of the compensation paid to all of the employer's employees, except for those employees properly excluded from membership.

(b) The percentage of compensation to be contributed under subsection (3)(a) is 1.27% for fiscal year 2014 and increases by 0.1% each fiscal year through fiscal year 2024. For fiscal years beginning after June 30, 2024, the percentage of compensation to be contributed under subsection (3)(a) is 2.27%.

(4) (a) The board shall annually review the additional employer contribution provided for under subsection (3) and recommend adjustments to the legislature as needed to maintain the amortization schedule set by the board for payment of the system's unfunded liabilities.

(b) The employer contribution required under subsection (3) terminates on January 1 following the board's receipt of the system's actuarial valuation if the actuarial valuation determines that terminating the additional employer contribution pursuant to this subsection (4)(b) and reducing the employee contribution pursuant to 19-3-315(2) would not cause the amortization period to exceed 25 years.

19-3-319. State contributions for local government and school district employers. (1) The state shall contribute monthly from the general fund to the pension trust fund a sum equal to 0.1% of the compensation paid to all employees of local government entities and school districts on and after July 1, 1997, except those employees properly excluded from membership.

(2) (a) Subject to subsection (2)(b), in addition to the contribution required under subsection (1), the state shall contribute monthly from the general fund to the pension trust fund a sum equal to 0.27% of the compensation paid to all employees of school districts except for those employees properly excluded from membership.

(b) The additional contribution under subsection (2)(a) terminates when the additional contribution under 19-3-316(3) terminates.

(3) The board shall certify amounts due under this section on a monthly basis, and the state treasurer shall transfer those amounts to the pension trust fund within 1 week. The payments in this section are statutorily appropriated as provided in 17-7-502.