MEMORANDUM

To: The Honorable Julie Dooling
Chair, Montana State Administration and Veterans' Affairs Interim Committee (SAVA)
The Honorable Llew Jones
Chair, Montana Legislative Finance Committee (LFC)

From: David Draine
Principal Officer, The Pew Charitable Trusts

Date: July 19, 2024

Subject: Summary of information and key points related to pension risk management presented by Pew staff to SAVA and LFC members pursuant to SJ 4 study

Chair Dooling and Chair Jones:

Thank you for the opportunity to present Pew's research and best practices to SAVA and LFC members tasked with implementing the study of the Montana Public Employees' Retirement System (PERS) and Teachers' Retirement System (TRS) pursuant to SJ 4 (2023) and the technical assistance letter dated December 2023. This memo summarizes the information and key points related to pension risk management presented by Pew for purposes of the SJ 4 study to date, namely on March 14 and May 23, 2024. In brief:

- All pension plans, including those in Montana, are subject to the inherent risks of market volatility.
- To ensure that pension policy will be sustainable even when things don't go as planned, state retirement systems and state policymakers need tools to *measure* and *manage* risk. Currently Montana has the former (i.e., stress testing) but not the latter for the PERS and TRS plans that represent about 80 percent of the state's retirement liabilities.
- The most recent stress test analyses for Montana pensions, published in 2020, show that Montana PERS had a 1 in 4 chance of insolvency from a combination of static funding policy and volatile investment results and Montana TRS had a similar risk of significant drops in plan funding. These risks persist despite reforms to address funding shortfalls in 2013; the policies that led to the 2020 stress test results—in particular a statutorily fixed contribution policy that does not

automatically respond when investments fall short or demographic experience leads to actuarial losses—remain in place for PERS and TRS.
- Ensuring actuarial funding targets are met is the foundation of any policy that would allow for a fiscally sustainable defined benefit pension plan like those in place for Montana workers. While there is no one-size-fits-all approach for states looking to ensure long-term pension sustainability in the face of volatile financial markets and an uncertain future, states like South Dakota, Tennessee, and Wisconsin offer successful examples with a range of plan designs, funding policies, and risk management tools.

The full summary of information and key points related to pension risk management presented by Pew begins on page 3 of this memorandum.

Please do not hesitate to contact our team with any additional questions or requests.

Respectfully,

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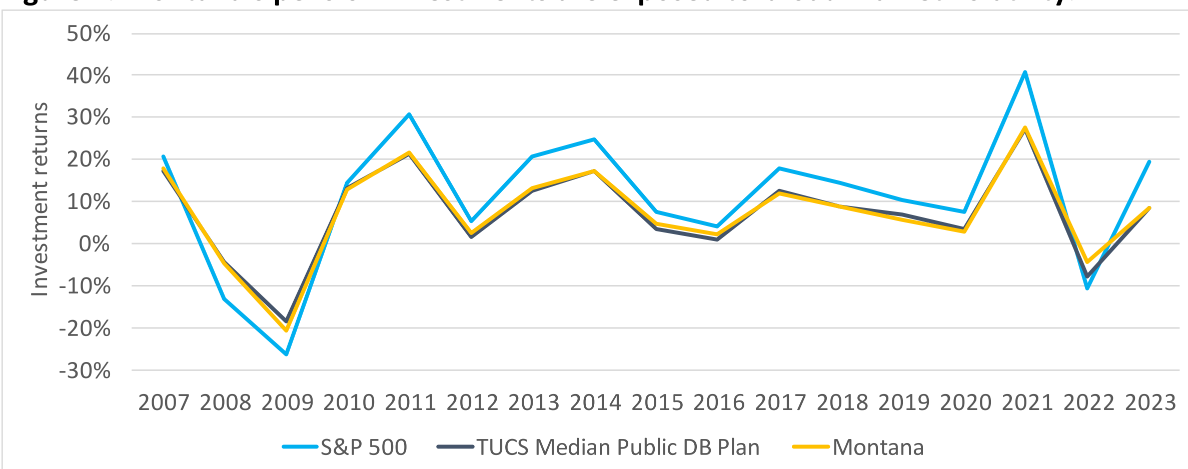
Summary: Information and Key Points Related to Pension Risk Management Presented by Pew to Montana SAVA and LFC Committees Pursuant to SJ 4

- State pension plans, including Montana's, take on risk to generate the returns needed to pay promised benefits. Pension fund performance in recent years—with windfall returns in 2021 followed by significant shortfalls in 2022 and a recent recovery in 2023—offer a reminder of the importance of having tools to measure and manage volatility.

Figure 1: Montana's pension investments are exposed to broad market volatility.



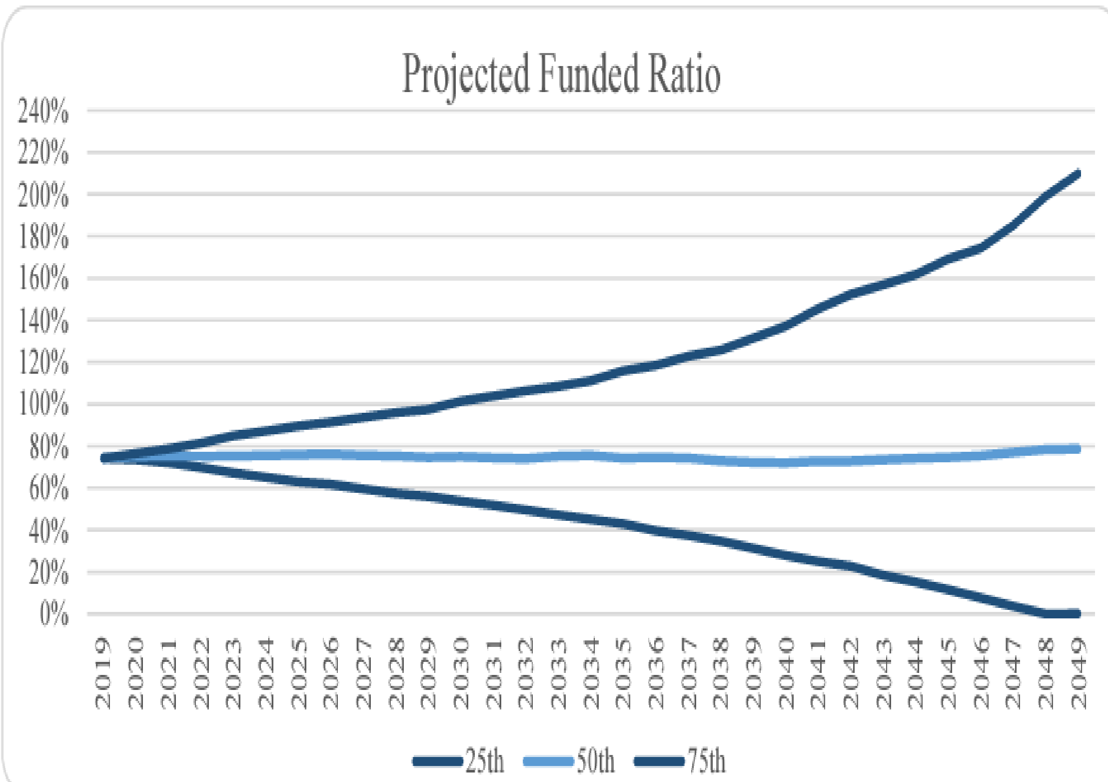
SOURCE: Median public plan data is from the Wilshire Analytics Trust Universe Comparison Service (TUCS). Montana returns are from the data submitted by the MT BOI for the May SAVA meeting.

- State pension plans reported an overall funded ratio of 82% in 2021—the highest level since the Great Recession. This means that even with windfall investment returns, state pension plans only had 82 cents for every dollar they should have had on hand to be on track to pay promised benefits. But that calculation depends on what will happen in the future—with investment returns, demographic trends, and changes to the public-sector workforce.

- For pension policy to be sustainable even when things don't go as planned, state retirement systems (and policymakers) need tools to *measure* and *manage* risk. Currently Montana has the former but not the latter for the PERS and TRS plans that represent about 80 percent of the state's retirement liabilities.

- Stress testing is a best practice for sustainable retirement policy to let policymakers and stakeholders know what will happen if investments or other important assumptions diverge from expectations. Montana conducts stress testing for PERS and TRS, with the most recent published stress tests covering the systems' condition as of 2020. Per those analyses, PERS had a 1 in 4 chance of insolvency from a combination of static funding policy and volatile investment results and TRS had a similar risk of significant drops in plan funding.

Figure 2: Projected funded ratios for Montana PERS vary based on different investment scenarios in the 2020 stress test.



SOURCE: Cavanaugh MacDonald, *Risk Analysis Report for the Public Employees' Retirement System of the State of Montana*. April 6, 2020. NOTE: This analysis is based on simulating different return scenarios based on Montana's funding and investment policies. The line labeled "50th" is the median, with half of the simulated scenarios having higher funded ratios and half of the scenarios having lower ratios. The line labeled "25th" represents a scenario for which there is a one in four chance based on the investment simulations of having that funded ratio or worse—and for Montana PERS, that scenario would result in insolvency.

- A lot has changed since 2020, and we understand that forthcoming stress testing analysis from Cheiron will provide more up-to-date forecasts for Montana PERS and TRS. But the policies that led to the 2020 stress test results—in particular a statutorily fixed contribution policy that does not automatically respond when investments fall short or demographic experience leads to actuarial losses—remain in place for PERS and TRS (though Montana recently adopted actuarial funding policies for smaller plans covering game wardens, judges, sheriffs, and highway patrollers).

- Ensuring actuarial funding targets are met is the foundation of any policy that would allow for sustainably running a defined benefit pension plan like those in place for Montana workers. Some states pair actuarial funding with tools to share risk through employee contributions or benefit designs. In a few instances, like South Dakota, adjustable benefits allow for a statutorily fixed contribution policy that is actuarially sufficient.

- **Montana's prior reforms in 2013 raised contributions to make up for past shortfalls but did not include any way to ensure that future shortfalls will be addressed.** The reforms also made an adjustable COLA for employees hired after 2013, but those changes will have limited impact on the state's legacy liabilities—and, as the 2020 risk analysis shows, are insufficient to ensure stable funding, let alone avoid insolvency.

- There is no one-size-fits-all approach for states looking to ensure long-term pension sustainability in the face of volatile financial markets and an uncertain future. States like South Dakota, Tennessee, and Wisconsin offer successful examples that represent a range of plan designs, funding policies, and risk management tools. But for long-term success in keeping pension promises, every state should have tools to understand the risks to public budgets and pension balance sheets *and* a ready answer for how to manage those risks.