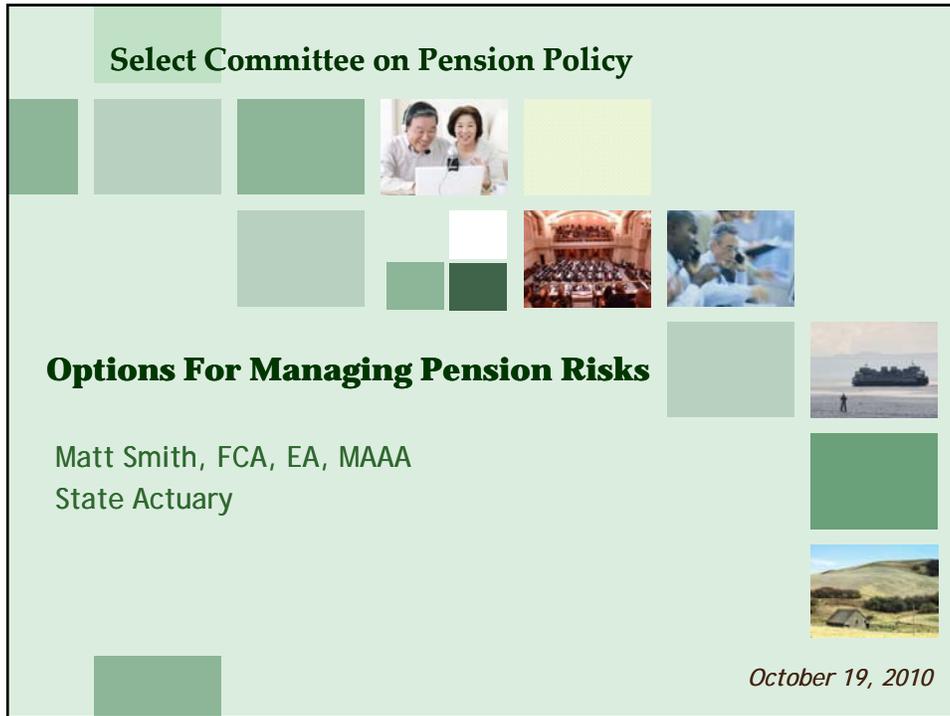


## Select Committee on Pension Policy



## Options For Managing Pension Risks

Matt Smith, FCA, EA, MAAA  
State Actuary

*October 19, 2010*

## Choose Your Side

**“Either you manage your risks, or  
your risks will manage you.”  
Unknown**

- What side of risk management do you want to be on?

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## Today's Presentation

- Identify options for managing key financial risks for pensions
- Recap of last month's presentation
- Risk versus affordability
- Legal background
- Discuss high-level options
- Next steps



## Sources Of Key Financial Risk For Pensions

- Funding deficiencies
- Unaffordable benefit improvements
- Untimely asset losses
- More details in last month's presentation

## Digging Deeper Identifies Root Sources

- Root sources for key financial risks
- Our reactions to
  - Increasing or unsustainably low contribution rates
  - Unsustainable short-term revenue growth
  - Unsustainable asset growth
- Lack of revenue when needed
  - We don't have the money
- Market risk combined with poor funded status
  - A poorly funded plan may have little time to recover from market losses



## Can We Control These Risks?

- We can control reactions to
  - Increasing or unsustainably low contribution rates
  - Unsustainable short-term revenue growth
  - Unsustainable asset growth
- We can't control
  - Market risks
  - Available revenue
- Managing controllable risk helps with risks we can't control
  - Less vulnerable with higher funded status

## Managing Risks Through Funding and Benefits Policy

- Fully fund the plans
- Fund more when you can
  - Anticipate revenue volatility and capitalize on short-term revenue growth when available
- Maintain minimum levels of funding
  - Recognize unsustainable revenue and asset growth
  - Additional safeguard beyond full funding
  - Without minimum funding you could fully fund inadequate contribution rates
- Additional considerations before adopting benefit improvements



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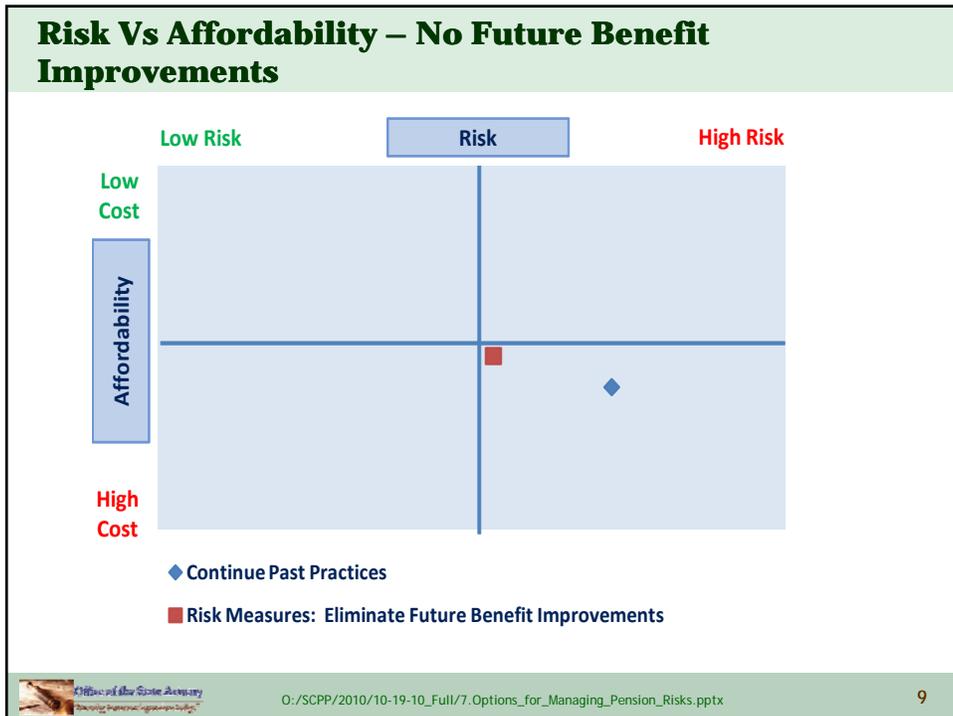
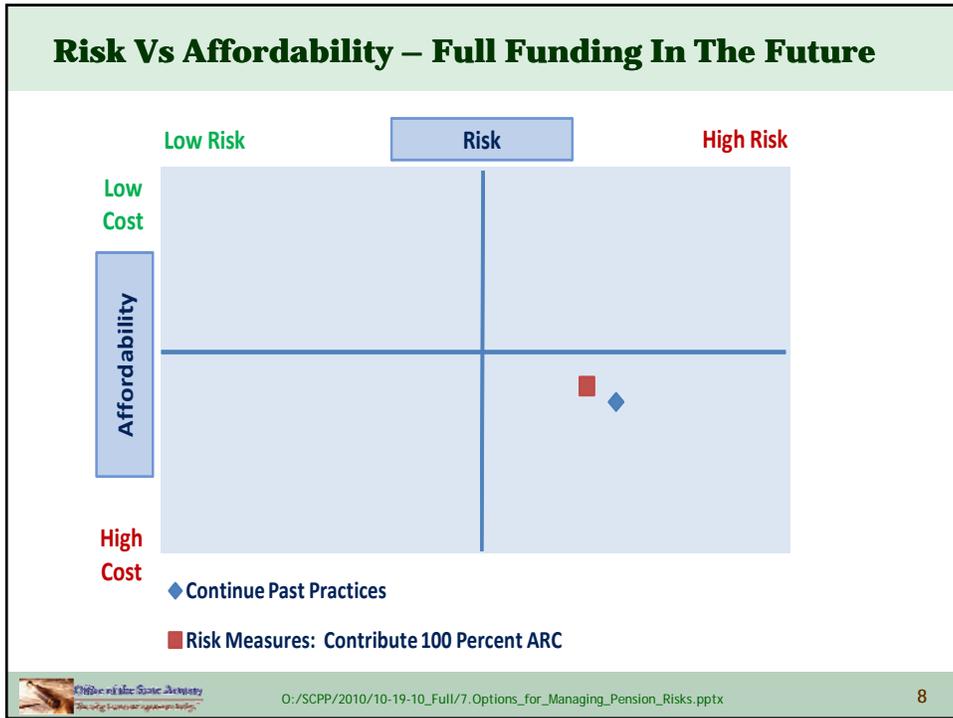
## Balancing Risk Reduction And Affordability

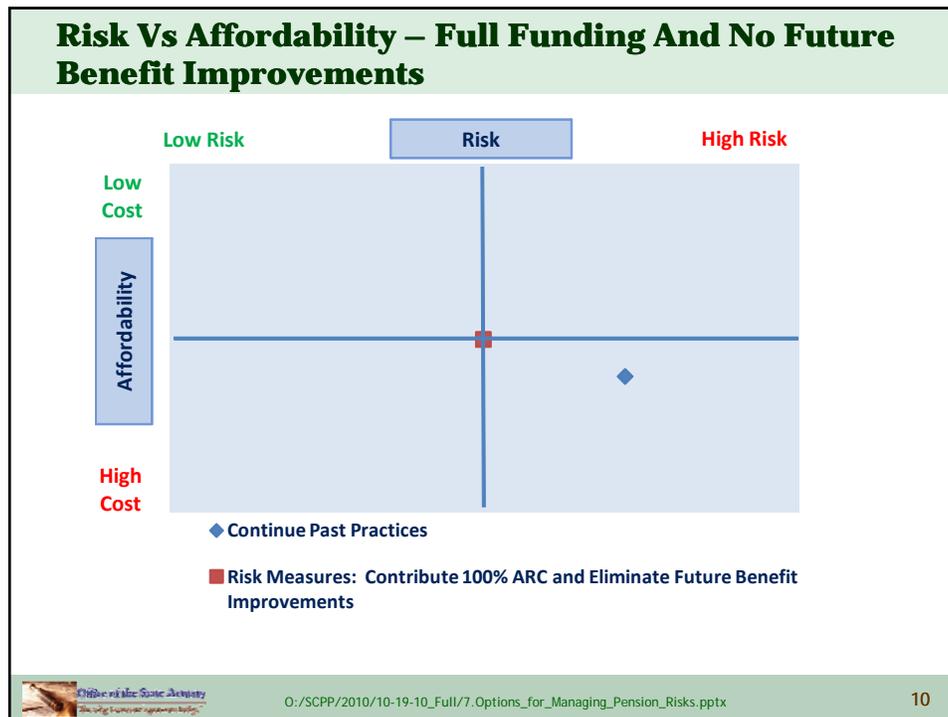
- An optimal solution will reduce financial risk to an acceptable level at the lowest cost
- Risk assessment examined
  - Continuation of past practices
  - Full funding in the future
  - No future benefit improvements
  - Illustrative scenarios only



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### Recap

- Key financial risks and root sources
- We can control some risks through funding and benefits policy
- Balance risk reduction with affordability
- Next up: risk management and options

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The only financial responsibility

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## Risk Management

- Where do we start?
- Managing the root sources of key financial risks
- Options can range from standard legislative changes to constitutional amendments
- Options can address future contractual rights

## Legislative Change Or Constitutional Amendment?

- Both have pros and cons
- Legislative change
  - Can't bind future Legislatures (i.e., prohibitions)
  - Requires simple majority of Legislature
  - Less enduring; easier to change
- Constitutional amendment
  - Can bind future Legislatures
  - Requires voter approval
  - Lasting; harder to change
  - Warrants additional careful consideration and legal analysis



## Contractual Rights

- Being examined and tested in other states
  - Increased level of employee cost sharing
  - Reduction in post-retirement COLAs
  - More to come?
- Currently under litigation in our state
  - Can the Legislature reserve the right to repeal an otherwise contractual benefit when it grants a new benefit?
- Contractual rights can transfer risk from the member to the system

## Questions To Consider On Contractual Rights

- What level of flexibility is required to maintain the financial integrity of the system?
- Should all future benefits require the same level of protection?
- Ultimately, what's best for members and the system?
  - Do we have the correct balance for the future?



## Options For Risk Management

- Multiple options available across funding and benefits policies
  - Not limited to one approach or one policy area
  - Possible consolidation
- Not an exhaustive list
- Intended to generate discussion
- Further analysis required
  - Beyond this interim depending on options selected

## High-Level Options

- Options for managing key financial risks
  - Fully fund the plans
  - Fund more when you can
  - Maintain minimum levels of funding
  - Additional considerations before adopting benefit improvements
- We'll review each separately



## Options – Fully Fund The Plans

- Risk management benefits
  - Reduces chance of pay-go
  - Lowers chance of developing unaffordable contribution rates
  - Less vulnerable to market risks with higher funded status
- How can we fully fund our plans?
  - Routine budget item at the discretion of Legislature?
  - Constitutionally protected like “debt service?”

## Fully Fund The Plans – Legislative Discretion

- Current practice
  - Funding policy currently in statute
- Allows greater flexibility
  - Helpful in times of crisis
- Can result in adverse/short-term funding decisions



## Fully Fund The Plans – Constitutional Protection

- New territory for Washington’s public pensions
  - Not common in other states
- Limited, or no flexibility depending on approach
  - Prescribed funding policy offers no flexibility
  - May add flexibility by allowing override by supermajority
- Avoids adverse/short-term funding decisions
  - Imposes external funding discipline

## Options – Fund More When You Can

- Risk management benefits
  - Helps manage revenue volatility
  - Increases chance of full funding over time
- How can we fund more when we can?
  - Through the pension system
  - Outside the pension system



## Options – Fund More When You Can

- Through the pension system
  - Adjust actual contributions to reflect available revenue
    - Overfund when revenue growth is favorable so you can underfund when revenue growth is unfavorable
    - Overfunding creates “credit balance” available for future use
    - No underfunding available without credit balance
- Outside the pension system
  - Pension stabilization account through state general fund
  - Dedicated stabilization fund under WSIB or OST
- Funding through the trust fund will dedicate the funds
- Funding outside the pension system not dedicated unless established in constitution



## Options – Maintain Minimum Levels Of Funding

- Risk management benefits
  - Less likely to adopt unsustainably low contribution rates
  - Helps to recognize the emergence of unsustainable asset growth
  - Less chance of adopting unaffordable benefit improvements
  - Improves funded status and protection against market risk
- How can we maintain minimum levels of funding?
  - Minimum contribution rates
  - Constitutional requirement



## Options – Maintain Minimum Levels Of Funding

- Minimum contribution rates
  - Currently in place, but suspended via legislation
  - Longer rate-setting cycles with stable long-term rates
- Constitutional requirement
  - Prohibit funding below minimum level
  - Require supermajority to adopt funding below minimum level
  - Remove incentives to change assumptions for short-term budgetary relief

## Options – Adopting Benefit Improvements

- Additional considerations before adopting benefit improvements
- Risk management benefits
  - Less likely to adopt unaffordable benefit improvements
  - Less chance of developing unsustainably high contribution rates
- Legislative and constitutional options available



## Options – Adopting Benefit Improvements

- Legislative options
  - Require immediate and full funding of any improvement that increases costs for service credit already earned
  - Separate funding source
  - Require sustainability analysis
  - Require sensitivity analysis on future assumed investment returns

## Options – Adopting Benefit Improvements

- Constitutional options
  - Prohibit if funded status below certain level
  - Require supermajority vote of Legislature under certain circumstances
  - Expressly state Legislature's right to repeal benefit improvements on a prospective basis under certain circumstances
  - Voter approval under certain circumstances



## Recap

- Balance risk reduction with affordability
- High-level options for managing key financial risks
  - Fully fund the plans
  - Fund more when you can
  - Maintain minimum levels of funding
  - Additional considerations before adopting benefit improvements
- Options can range from legislative changes to constitutional amendments
- Could consider future contractual rights
- Further analysis required
  - Beyond this interim depending on options selected

## Next Steps

- SCPP or Executive Committee direction on options to pursue
- Based on that direction, OSA will analyze and report back

