

# Options for Managing Pension Risks: Constitutional Amendment

This handout is a "menu" of possibilities for managing key financial risks for pensions by amending the state constitution. Some ideas have been discussed by the SCPP and others in the past. Some ideas are new. Some of the options are general principles and some are very specific. Some suggestions are substantive and some are procedural. The options presented are not all-inclusive. They are aimed at improving financial risk measures identified in the 2010 Risk Assessment in the areas of funding, benefit improvements and Plan 1 legacy costs. See the Office of the State Actuary's 2010 Risk Assessment at the following link for additional background:

[osa.leg.wa.gov/Actuarial\\_Services/RiskAssessment/RA.htm](http://osa.leg.wa.gov/Actuarial_Services/RiskAssessment/RA.htm)

These are not OSA recommendations. This handout is a discussion document designed to expose the SCPP to a variety of options for utilizing constitutional amendments as tools for managing financial risks. As discussed in earlier briefings, there are pros and cons to constitutional amendments, and there will be pros and cons to the options outlined below. For a summary of last interim's briefing, see page 77 of the 2009 Interim Issues Full Report at the following link:

[leg.wa.gov/SCPP/Documents/2010/2009Intlss/2009\\_FR.pdf](http://leg.wa.gov/SCPP/Documents/2010/2009Intlss/2009_FR.pdf). See also the State Actuary's presentation at the October 19, 2010, SCPP meeting entitled Options for Managing Pension Risks: [leg.wa.gov/SCPP/Documents/2010/10-19/7.PPT\\_Options.pdf](http://leg.wa.gov/SCPP/Documents/2010/10-19/7.PPT_Options.pdf).

## A. Funding

The 2010 Risk Assessment found that over the past twenty years the largest state pension plans received about 80 percent of the contributions they needed under the funding policies in place at the time. The Risk Assessment also found that asset gains from positive investment returns were captured early and subsequent losses were deferred. These short-term funding policies resulted in additional underfunding over the past twenty years. A funding mandate in the state constitution would force the Legislature to provide a specified level of pension funding each year and could reduce or eliminate budgetary flexibility to underfund pensions.

### 1. Annual Funding at 100 Percent

This option would require the Legislature to assure that the total contribution rate for each state-administered pension plan is sufficient to fully fund, on an annual basis, 100 percent of the expected long-term annual cost of the plan.

**(a) Procedural Flexibility**

Would required funding be too onerous? Should there be an opportunity for legislative flexibility when tax revenues falls short? The stricter the constitutional mandate, the more desire there may be for an "out." One way to provide this would be to allow exceptions based on the affirmative vote of a supermajority, e.g. three-fifths, two-thirds, or three fourths of the members the House and Senate. Balancing the original mandate with flexibility becomes critical, as the mandate can be rendered meaningless if the flexibility is too great.

**(b) Dedicated Reserves**

If there is concern that tax revenues may not be available to live up to the mandate, it might be necessary to add an option requiring "overfunding" when revenue growth is strong. Putting more money into pensions in good times would create a source of funds (i.e., a "credit balance") to tap into when revenue growth is unfavorable. Safeguards could include only allowing underfunding when there is an available credit balance.

Another approach, outside the pension system, could be to require that part of the state's rainy day fund be earmarked for pensions. The Legislature could transfer earmarked funds to make a portion of the state's required contributions for pensions when revenue growth is unfavorable.

## ***2. Annual Minimum Funding at 80 Percent***

If a full funding mandate is too strict, a minimum funding mandate could be implemented. Under this option, the Legislature would be required to assure that the total contribution rate for each state-administered pension plan is sufficient to fund, on an annual basis, 80 percent of the expected long-term annual cost of the plan.

Minimum rates are a tool for stabilizing pension contributions. They can help prevent contributions from dropping to artificially low levels when markets are volatile. The Pension Funding Council adopts contribution rates, and the Legislature can amend them if it so chooses. Under this option, the Legislature would have a duty to assure that the adopted rates meet the 80 percent standard.

The 80 percent standard is consistent with current funding policy for the open plans. Placing this funding standard in the constitution would mandate minimum funding and take away the Legislature's ability to reduce funding below these floors when it passes the budget bill. The 80 percent standard would not prevent the Legislature from providing full funding or from funding pension reserves.

The need for legislative flexibility or pension reserves may not seem as compelling if the constitutional mandate is minimum funding instead of full funding. However there is more long-term financial risk if minimum funding is the standard and not full funding. Additionally, even a minimum funding standard could prove onerous during

weak economic environments prompting the need for potential legislative flexibility or pension reserves.

### ***3. Waiting Period for Changes to Methods or Assumptions***

Another way to help reduce or eliminate outcomes that result in underfunding might be to require a waiting period before a change in actuarial methods or assumptions can become effective. For example, a two-year waiting period could deter policy makers from making assumption or method changes for the primary purpose of reducing contribution rates in an upcoming biennium.

## **B. Benefit Improvements**

The 2010 Risk Assessment found that over the past 20 years, benefit improvements increased liabilities in the largest state pension plans by .45 percent annually. Constitutional provisions could be used to limit how much liability is added to these plans in the future. The constitution could allow for flexible benefits that can be adjusted in the future, or it could mandate stricter funding policies for new benefit improvements.

Several examples are provided below. These approaches would require close attention in future legislative enactments. Statutes and (if needed) rules would specify how these principles would be carried out for specific benefit improvements.

### ***1. Flexible or Non-Contractual Benefits***

Under this option, lawmakers would be given the explicit authority to designate a new benefit improvement as discretionary or non-contractual. The goal would be to provide clear flexibility to adjust the new benefit in the future. This option could allow the Legislature to reduce, withhold or repeal such benefits. The flexibility could be very broad, or it could be contained. For example, the ability to reduce, withhold, or repeal discretionary benefits could be limited to benefits not yet earned. This would protect benefits already paid and benefits for service that has already been earned.

### ***2. Strict Funding Policy for Retroactive Benefit Improvements***

Under this option a strict funding policy could be adopted for retroactive benefit improvements. Retroactive benefit improvements reach back in time and apply to service that was earned in the past. This creates what's called "unfunded prior service" costs since the previous contributions made on past service did not anticipate a higher cost from the subsequent benefit improvement. This type of benefit improvement can add significant unfunded liability to a pension plan. To avoid passing unfunded costs from these kinds of benefits on to future generations, a

constitutional amendment could require that new benefit improvements for past service be fully funded over a short period of time. For example they could be funded over the year or biennium in which they are enacted. This effectively means that a funding source for a retroactive benefit improvement must be immediately available.

### ***3. Avoid Improvements to Unhealthy Plans***

This option could limit or prohibit benefit improvements for plans with a funded status below a certain threshold - say, 80 percent. Funded status is the relationship between assets and accrued liabilities at a given point in time. If the funded status is 100 percent, then there is one dollar in actuarial assets for each dollar of accrued liability (earned benefits). Eighty percent is a common threshold used in the private sector to distinguish healthy plans from unhealthy plans.

### ***4. Supermajority or Voter Approval***

This option could require a supermajority of the Legislature, or even voter approval to add new unfunded benefits to pension plans. The greater the potential liability, the more there may be a need for additional caution. Procedural hurdles could discourage the addition of significant new unfunded liabilities. One challenging aspect of this approach is how to develop triggers that are practical and stand the test of time.

## **C. Plan 1 Legacy Costs**

Plan 1 legacy costs were approaching \$7 billion as of June 30, 2009 (the date of the most recent actuarial valuation). There is a statutory funding method (currently suspended in order to provide budgetary relief through 2015) for paying off the Unfunded Actuarial Accrued Liabilities (UAAL) for the Public Employees' Retirement System (PERS) 1 and the Teachers' Retirement System (TRS) 1. A constitutional amendment could mandate that this funding method be followed.

### ***1. Annual Minimum Funding Until Legacy Costs Are Fully Paid***

This option would require the Legislature, beginning in 2015, to assure that minimum amounts are contributed each year to pay off the UAAL in PERS 1 and TRS 1. This minimum obligation can be expressed as a percentage of pay for all active employees.

The Legislature need not be limited to contribution rates as the sole source for contributions as long as the amount of the minimum contributions is clear. The Legislature is then free to collect the contributions as a percentage of pay, or to raise the required amounts by some other means. The Legislature is also free to pay off legacy costs more quickly if it so chooses.

Minimum funding would exclude amounts that might be collected for new benefit improvements. The minimum amounts would remain in effect for each plan until the plan's UAAL is fully funded.

## ***2. Prevent Legacy Costs from Re-Emerging***

The constitution could require the Legislature to reasonably assure that once the UAAL is fully funded, it will not re-emerge. Legislative strategies to implement such a principle could include funding policies as well as investment policies. The implementing policies would not necessarily be needed in the constitution as long as the goal or principle is clear.

Examples of such policies would be requiring that contributions be collected until the plans are more than 100 hundred percent funded so that there is a cushion to absorb market fluctuations. Another example would be to transition assets into "safe" investment vehicles (i.e. lower risk, lower returning asset classes) once full funding is achieved.

## **Next Steps**

There is a wide range of available options:

1. Take no further action.
2. Develop an SCPP recommendation.
  - a. Pursue one or more of the options discussed.
  - b. Develop one or more new options.
3. Study or endorse another proposal.
4. Pursue strategies other than constitutional amendments.

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SENATE JOINT RESOLUTION 8223

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State of Washington

61st Legislature

2010 Regular Session

By Senators Schoesler, Hobbs, Hewitt, Murray, Honeyford, Parlette, Shin, Berkey, Sheldon, Becker, King, Holmquist, Stevens, Pflug, McDermott, Swecker, McCaslin, Delvin, and Kilmer

Read first time 01/19/10. Referred to Committee on Ways & Means.

1 BE IT RESOLVED, BY THE SENATE AND HOUSE OF REPRESENTATIVES OF THE  
2 STATE OF WASHINGTON, IN LEGISLATIVE SESSION ASSEMBLED:

3 THAT, At the next general election to be held in this state the  
4 secretary of state shall submit to the qualified voters of the state  
5 for their approval and ratification, or rejection, an amendment to the  
6 Constitution of the state of Washington by adding a new section to read  
7 as follows:

8 Article . . . , section 1. (1) Prior to the beginning of each  
9 biennium, the state actuary, appointed and authorized as provided by  
10 statute, or successor entity, shall conduct an actuarial valuation of  
11 all state-administered public employee retirement plans. The state  
12 actuary's valuation shall be subject to an independent actuarial audit.

13 (2) The pension funding council, appointed and authorized as  
14 provided by statute, or successor entity, shall utilize the actuarial  
15 valuation and audit to determine employer retirement contribution rates  
16 in all state-administered public employee retirement plans for the  
17 upcoming biennium.

18 (3) Each biennium the legislature shall appropriate moneys to fund  
19 the state employer retirement contribution rates identified in

1 subsection (2) of this section. Legislative action that would result  
2 in employer retirement contribution rates in any state-administered  
3 public employee retirement plan being less than the amount determined  
4 in subsection (2) of this section shall require a vote of three-fifths  
5 of the members elected to each house of the legislature, unless the  
6 reduction is the result of statutory modifications to retirement  
7 benefits not guaranteed by this Constitution.

8 (4) This section does not create or alter any contractual,  
9 statutory, or constitutional rights to receive public employee  
10 retirement benefits.

11 BE IT FURTHER RESOLVED, That the secretary of state shall cause  
12 notice of this constitutional amendment to be published at least four  
13 times during the four weeks next preceding the election in every legal  
14 newspaper in the state.

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# Pension Funding Reform for Washington State

Washington State Treasurer

**James L. McIntire**

September 13, 2010





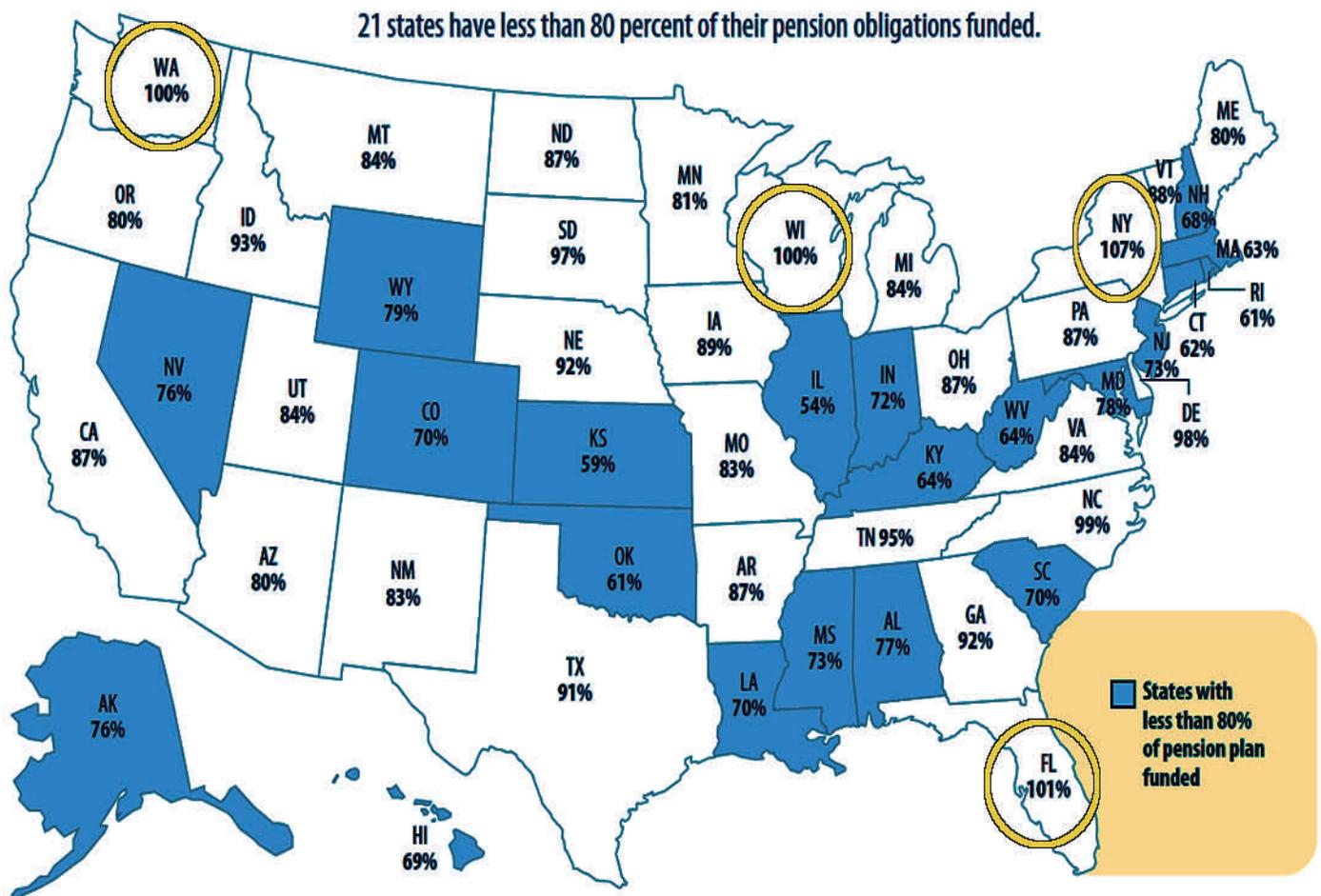
Washington State Treasurer  
James McIntire

# Pension Funding Reform For Washington State

The 2010 Risk Assessment completed recently by the State Actuary at the direction of the State Select Committee on Pension Policy calls for sustained pension contributions from employers and employees that when effectively invested will properly pay the costs of public employee pensions.

Recent national news stories about strapped state finances often highlight pension funding as one of the most serious challenges facing state and local governments. Surprising for some, the State of Washington does well in these rankings. The Pew Research Foundation's recent analysis (*The Trillion Dollar Gap*, Pew Charitable Trust, 2010) of state pensions ranked Washington fourth in the country for combined funding of its 13 pension programs.

**Figure 1. Washington State is a national model for pension reform**



SOURCE: Pew Center on the States, 2010.

On the whole, this ranking is well deserved and was just substantiated by the State Actuary's most recent analysis (*2010 Risk Assessment*, Office of the State Actuary). Washington's 10 ongoing pension plans – the plans that are open and accepting new employees – are funded at 118 percent of future liabilities.

***Washington led the nation in closing down its poorly funded, "California-style" high benefit plans in 1977.***

And, the Washington State Investment Board has averaged over 8 percent annual return on pension funds for the past 20 years.

Despite these excellent results, the Risk Assessment makes clear that Washington still has a pension funding problem because two of the three pension systems closed in 1977 were historically underfunded – a problem that grows worse as the bills come due when these participants retire. PERS1 and TRS1 cover state and local public employees and school teachers who entered public service prior

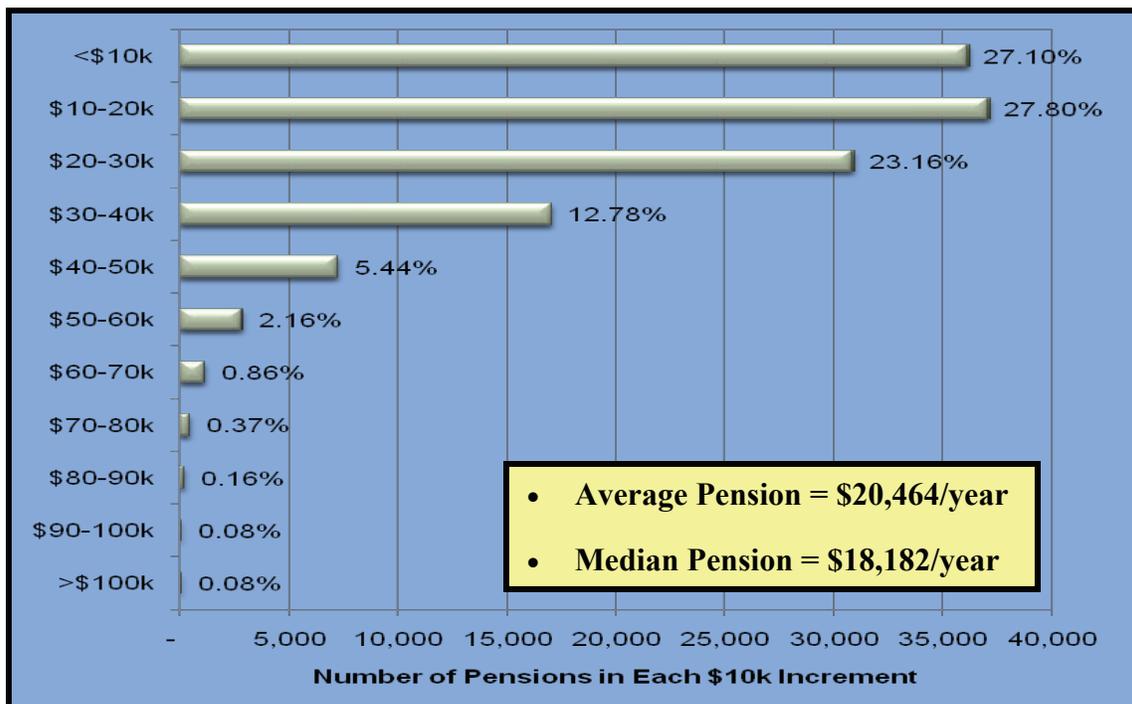
to 1977. The pension benefits owed to these public servants are constitutionally protected by contract, and state and local governments (including school districts) must pay them.

As the Risk Assessment documents, because these two plans were underfunded numerous times since 1977 they are now currently funded at only 72 percent of future liabilities. Much like bonds issued to build roads and schools, these liabilities must be paid – they cannot be avoided or reduced by initiative or actions of the Legislature.

Chronic underfunding of these two closed plans has caused an unfunded liability of \$6.9 billion with the state on the hook for \$3.8 billion and local governments for \$3.1 billion.

If the Legislature is unable to take the dramatic steps necessary to consistently fund these liabilities over the next 20 years through the regular budget process, then it may be necessary to lock a payment schedule into the State Constitution so that it can't be easily changed by the Legislature.

***Over 96 percent of retirees get annual benefits of \$50,000 or less, only 112 people get benefits in excess of \$100,000 per year.***



## **Not a Benefit Problem**

When hearing of this problem for the first time, some people jump to the conclusion that public pension benefits are too rich. While this may be true in other jurisdictions, here in Washington this is simply not the case.

Overall, Washington's public pension plans cover 302,000 current employees and 133,000 retirees. Over 96 percent of retirees get annual benefits of \$50,000 or less, only 112 people get benefits in excess of \$100,000 per year, most were judges, local government officials, university administrators and professors, utility district officials, and school district administrators – only two were from what most would recognize as state agencies.

### ***The average annual public pension is just under \$20,500***

All these employees have shared in the contributions to their pensions (Department of Retirement Systems, 2010).

To be sure, the benefits for the closed PERS/TRS 1 plans are more generous than benefits for the ongoing, open pension plans. Under the closed plans, employees could retire at any age after 30 years of service with a pension equal to 60 percent of the average of their three highest years of pay – but even for these plans the average payment is only \$21,200 per year (Office of State Actuary, 2010).

Most new public employees have the option of enrolling in either a defined benefit program or “hybrid” defined-benefit-defined-contribution pension program. In these programs, the defined benefits are based on the average of the highest five years of employment and employees can only retire after reaching age 65 (though it is possible to retire at age 55 with at least 20 years of service with benefits substantially reduced by actuarial formula). Benefits for retirees under the open, ongoing, de-

defined benefit plans average \$19,300 per year (for the same years of service as the Plan 1 average years of service). These plans are now being copied by other states trying to reform their pension programs.

This is not to say that some benefit modifications may not be in order. For example, concern about “rich” benefits may prompt the Legislature to adopt caps on the maximum annual pension payment, or tighter controls on “retire-rehires” to eliminate some abuses.

The Risk Assessment suggests that over the past 20 years, benefit enhancements have added costs at a rate of 0.45 percent per year, including two large spikes in the past 10 years. It is important to note that the last of these spikes in 2007 incorporated a series of benefit enhancements combined with a repeal of non-contractual benefits enacted in 1998 in an attempt to rollback what were seen as expensive and poorly designed benefits. These repealed benefits only show up as costs during the 1998-2007 period, and no offsetting liability reduction was recorded in 2007 because they were not contractual obligations of the state. This legislation is currently being challenged in court, and serves as an illustration of the complexities in implementing benefit reforms.

## **Not a Health Insurance Funding Problem**

Retirees get access to health care benefits through the state, but Washington does not provide a contractual health insurance benefit to its retirees. Instead, for pre-Medicare retirees the state lets them use their own money to pay for the same health insurance provided for public employees, but they get to pay group-rate costs for the coverage. While this does not create a contractual liability for the state, it does provide an indirect subsidy to retirees because the state's group rate would be lower if this generally older population were not part of the purchasing group.

For Medicare-eligible retirees, the state does pro-

vide an explicit subsidy that goes to reduce their Medicare Part A and B premiums. The amount provided by the state is a set dollar amount determined each year by the Public Employee Benefits Board (PEBB). This benefit is included in each year's state budget and, like the implicit subsidy, it is not a contractual benefit. The federal government rebates part of this annual amount to the state but government accounting rules do not allow the rebate to count against the subsidy – even though private-sector accounting rules do allow such an offset.

According to Governmental Accounting Standards Board rules, public entities must estimate and report future health insurance costs for retirees, regardless of whether they are contractual or not. As a result, Washington reports an “unfunded liability” for retiree health costs of \$4.01 billion in its *2009 Comprehensive Annual Financial Report* (page 162). Because these are not contractual benefits, the state does not fund them in advance. If the state were to reserve even a dime against this “unfunded liability,” it would create a contractual benefit for which the state could be held liable but is not currently obligated to fund.

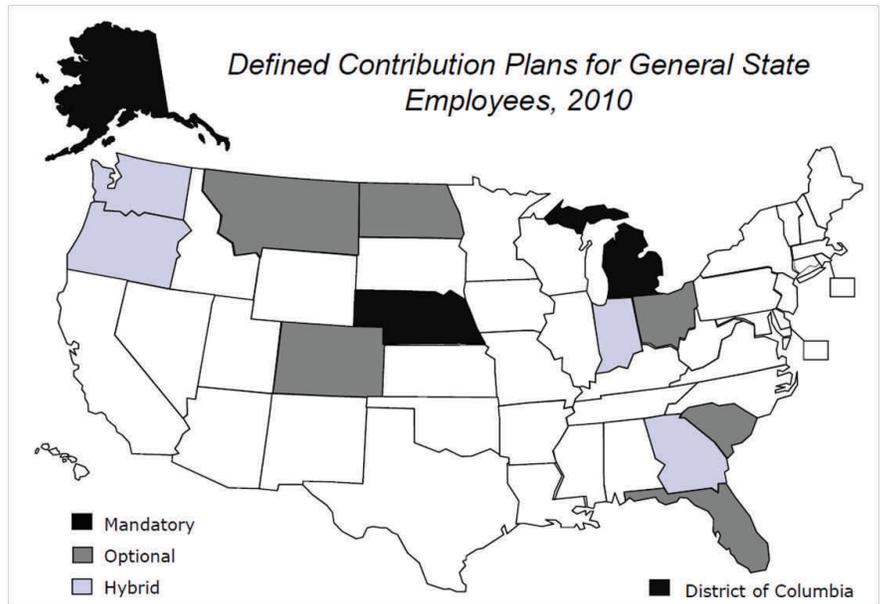
Local governments in Washington do have an unfunded health insurance liability under the pension plan for police and firefighters (LEOFF1) that was also closed in 1977. This unfunded liability is estimated to be roughly \$1.7 billion (*LEOFF 1 Medical Benefits Study, Office of State Actuary 2007*). This is a contractual benefit between local employers and their retirees but is not a state obligation. However, the fiscal stress caused for local governments as they pay LEOFF1 health benefits will affect their capacity to adequately fund their unfunded liability for PERS1.

## A Defined Contribution Pension Plan May Increase Costs

If funded and invested properly by an employer,

contributions to a defined benefit should be lower because they typically represent only 25 percent of the benefits paid – the other 75 percent should come from investment returns.

A popular policy solution now being touted for public pensions is to close the defined benefit plans and create a series of defined contribution plans – where the employer and employee contribute an equal percentage of pay to a 401k plan. While common among private sector businesses, this approach will



neither solve Washington's underfunding problem nor control costs going forward.

There are several reasons why private sector employers moved to defined contribution plans. Mobility among workers increased in the 1980s in private labor markets, which increased the importance of pension plan portability for employees. At the same time, corporations with defined benefit plans that were funded in excess of 100 percent became targets for takeover – when many of these plans were closed and excess assets were used to pay for the takeover financing. Once clear of their past pension obligations – and oftentimes labor contracts – employers could set up defined contribution programs at lower costs going forward.

In contrast, defined benefit plans encourage and compensate the kinds of longer term employment

relationships that are more common in public service (e.g. police, firefighters, and teachers) where wage growth is limited and productivity benefits of long term employment are greater. In addition, federal and state laws pertaining to public pensions differ from those governing private plans. Private employers can reduce benefits under economic duress, while public employers are contractually bound to pay the benefit commitments they make when people are hired.

When compared with defined benefit pension plans, defined contribution pensions shift investment risks from the employer to the employee – which in the public sector is usually accompanied by an increase in the employer’s contribution to facilitate the conversion. The benefit to the employer in this arrangement is that they no longer have either liability for future payments nor risk of investment loss. In turn, employees are compensated for the risk of investment loss by the higher employer contribution.

In Washington, because professors often move from one institution to another, public universities offer their faculty access to TIAA-CREF, a national defined contribution retirement plan for higher education faculty. Employee contributions to this plan are matched by the state at rates of between 5 percent (for younger faculty) and 10 percent (for those over age 50) of salary – *higher* employer costs than those for PERS2 where the long term employer cost is just under 5 percent of salary (State Actuary, entry age rate).

A few states have experimented with defined contribution plans. Michigan, for example, implemented a defined contribution plan where the state employer matches employee contributions for a minimum of 4 percent of salary and a maximum of 7 percent of salary. Nebraska closed its defined contribution plan in 2002 and implemented a cash balance plan for new employees in 2003 with an employer contribution rate of

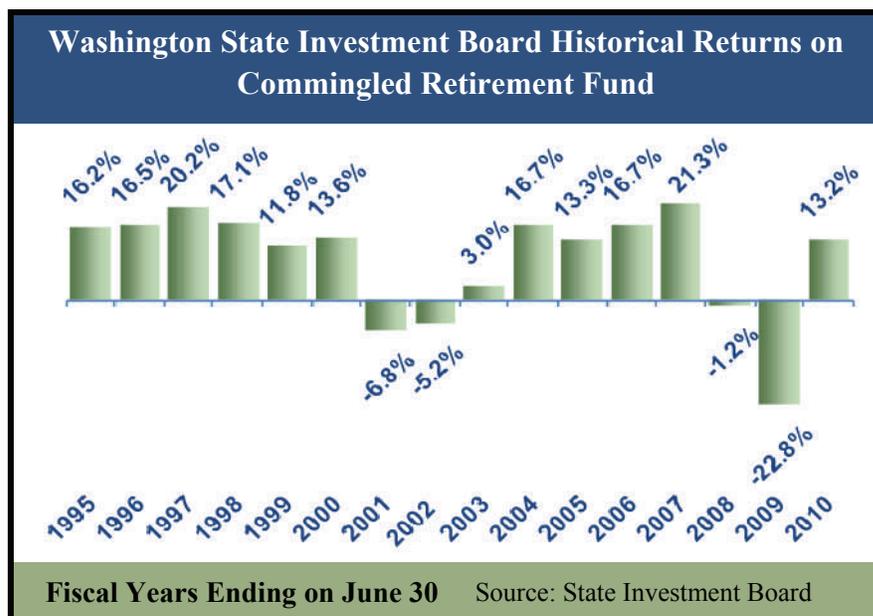
7.5 percent of salary and a guaranteed annual return of at least 5 percent per year (*State Retirement Systems Defined Contribution Plans, NCSL 2009*).

Finally, even if a defined contribution plan could be adopted at a lower contribution rate, it would only apply to new employees at a time when public sector employment is declining, not increasing, offering little near-term opportunity for increased savings. Furthermore, such a plan would do nothing to amortize the unfunded liabilities for the PERS/TRS plans 1, or commit the Legislature to an amortization plan.

## Not an Investment Problem

The massive loss of wealth across all asset classes during the recent financial crisis affected virtually all retirement accounts, from public pensions to private retirement accounts. Even some of the most conservatively managed funds with higher allocations to fixed income investments such as the Missouri Department of Transportation and Patrol Retirement System, and the Tennessee Consolidated Retirement System, lost 25 percent and 15 percent respectively in the downturn. Washington’s pension fund loss of 23 percent was no exception.

What is exceptional about Washington is that a year later, the average annual return for the State Invest-



ment Board’s Combined Trust Fund (CTF) since inception exceeds 8 percent and its performance was among the top one percent of public pension funds in the country during the past 20 years, and they were in the top 10 percent during the past five years. The CTF global investment strategy is relatively unique in its emphasis on private company and real estate investments. This strategy has enabled the state to out-perform nearly all of its peers by making investments that can be actively managed to produce higher returns within prudent risk, rather than passively depend on market performance. We are certainly in times that test our investment conviction, but our long term performance is very good and our investment portfolios are positioned well for the future.

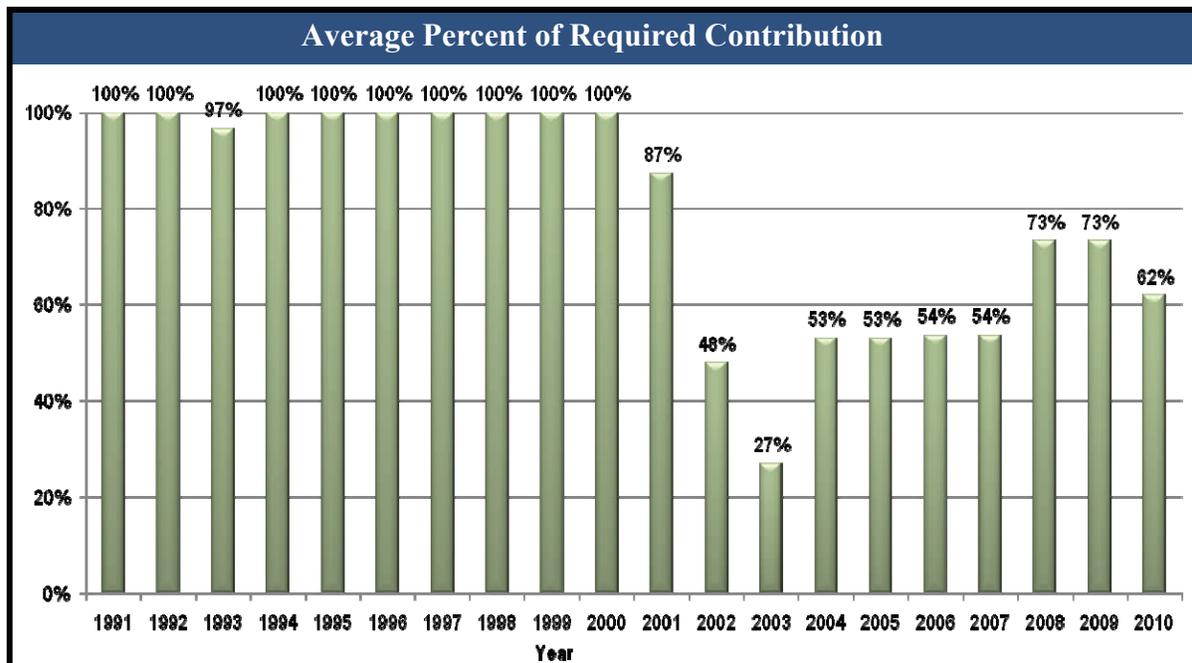
While there may be some legitimate concern about the ability of future returns to equal past performance in this new financial reality, it is not clear that there is another investment model that would out-perform the one in place. Some strategies might produce less volatility, but in doing so they would also produce lower returns, and as a result, require higher contributions.

## Adequate Funding Requires an Institutional Solution

Underfunding PERS1 and TRS1 started soon after the plans were closed in 1977. The recession of the early 1980s brought dramatic revenue shortfalls, and a well-intended plan to amortize the unfunded liabilities was scrapped. This amortization plan was subsequently replaced after the recession with a plan that called for capitalizing interest payments (making payments that did not cover interest costs) until 2009 – adding to the unfunded liability.

An important factor that compounds the funding challenge is the link between state, local government and school district pension contributions. Any action by the Legislature for state employees has the same repercussions across all units of government.

Over the years, legislative pension funding debates demonstrate the institutional difficulty faced by both parties as they try to reduce spending and/or increase revenue to balance budgets – often at the expense of adhering to the State Actuary’s recommended pension contribution rates. As the Risk Assessment points out, underfunding of pensions is



Source: Washington State Department of Retirement Services

correlated with volatility in both investment returns and state revenues:

We observed that weak economic environments were correlated to weak investment returns. Lower investment returns created the need for increased contributions at a time when employers and members could least afford them.

Also, we saw that the likelihood of required contributions being made was less when the previous year’s contributions were already lower than what had been required. Contribution rates were at their lowest early in the second decade. Even when revenue growth peaked in the middle of the decade, contributions were still roughly half of what was required.

Once dollars are budgeted away from pensions, it may be difficult to move them back. We saw in the twenty-year look-back that restoring contributions to higher budget levels took longer than it took for investment returns and revenue growth to improve.

Over the past twenty years we saw that when asset returns were low and there was pressure to increase contribution rates, revenue

growth was also low, making it very difficult for policy makers to respond to the pressure. We noted that if fully funding pensions did not or could not occur when there were economic downturns, then there were implications for long-term financial risk. Moreover, if underfunding still occurred when revenues and asset values were trending up, there was even more risk to consider. (*Risk Assessment*, pp. 23-4)

In 2006, the Legislature became increasingly aware of this policy-based risk and passed by unanimous vote a statutory plan to amortize the PERS/TRS plan 1 unfunded liability and establish a floor on employer contributions for all open public pension plans. If followed, this statute would have ensured that contributions would never fall below 80 percent of the State Actuary’s recommendation – a carefully crafted measure that would keep the Legislature from “robbing Peter to pay Paul” by underfunding the open plans to fund the closed plans. Unfortunately, when faced with a \$9 billion budget gap in the 2009 session, the Legislature narrowly passed SB 6161 to move the implementation date for this law ahead to July 2011.

<b>Calculation of 2009 Funded Status*</b>					
<i>(Dollars in millions)</i>					
		<b>Accrued Liability</b>	<b>Valuation Assets</b>	<b>Unfunded Liability</b>	<b>Funded Ratio</b>
<b>PERS</b>	<b>Plan 1</b>	\$ 13,945	\$ 9,776	\$ 4,169	70%
	<b>Plans 2/3</b>	\$ 15,701	\$ 18,260	\$ (2,560)	116%
<b>TRS</b>	<b>Plan 1</b>	\$ 10,838	\$ 8,146	\$ 2,692	75%
	<b>Plans 2/3</b>	\$ 5,213	\$ 6,160	\$ (947)	118%
<b>SERS</b>	<b>Plans 2/3</b>	\$ 2,162	\$ 2,503	\$ (341)	116%
<b>PSERS</b>	<b>Plan 2</b>	\$ 54	\$ 69	\$ (15)	128%
<b>LEOFF</b>	<b>Plan 1</b>	\$ 4,477	\$ 5,612	\$ (1,135)	125%
	<b>Plan 2</b>	\$ 4,325	\$ 5,564	\$ (1,239)	129%
<b>WSPRS</b>	<b>Plans 1/2</b>	\$ 758	\$ 900	\$ (143)	119%
<b>ALL PLANS</b>		<b>\$ 57,473</b>	<b>\$ 56,991</b>	<b>\$ 481</b>	<b>99%</b>

Source: OSA 2010 Risk Assessment

A looming \$3 billion (or larger) shortfall for the 2011-13 biennium now awaits the 2011 Legislature – just after they filled a 2010 budget gap of roughly the same size. A major contributing factor to the shortfall is the State Actuary’s recommendation that employer contribution rates for state government

***It may well be time for the Governor and Legislature to seriously consider amending the state Constitution with a funding plan.***

should increase from their 2009-11 level of \$770 million to \$1.48 billion for 2011-13. Costs will go up for local governments and school districts from \$950 million to \$1.71 billion.

Even though the Pension Funding Council recently voted to adopt these employer contribution increases, there will be enormous pressure to underfund them in what will be an excruciating decision-making process as the final biennial budget is written. But, any attempt to underfund the now-adopted State Actuary recommendations means the Legislature must again set aside the law that requires amortizing the unfunded liability and making needed contributions to the open plans.

Should this happen, it may well be time for the Governor and Legislature to seriously consider amending the state Constitution with a funding plan similar to the statutory plan. In the current and foreseeable funding environment, it has become institutionally difficult for either party to put together the majority votes necessary to adopt the reductions in spending and/or increases in taxes that would be required to fully fund the State Actuary’s recommended pension contributions. If the statutory am-

ortization schedule for the PERS/TRS1 liabilities and the requirement for funding at least 80 percent of the State Actuary’s recommendations for open plans were imbedded in the State Constitution, then it would require a two-thirds vote of the Legislature and a vote of the people to set that requirement aside. This measure would *require* adequate funding.

Useful additions to this plan would be requirements that additional benefits are fully funded when adopted, and that implementation of changes in economic assumptions be prohibited for two years if the changes have the effect of lowering the contribution rates. It is important to note that these constitutional requirements would be neutral with regard to the state’s policy choice between defined benefit and defined contribution plans.

Other constitutional approaches may be appropriate. For example, private sector pension plans are required under federal law to make mandatory contributions to any pension plan where funding falls below 70 percent. Perhaps the state could establish a similar, higher standard, in the constitution. Given that the employer contribution rates are scheduled to dramatically increase again in the 2013-15 biennium, constitutional pension funding reform is likely to be necessary to create the institutional and structural discipline required to amortize our unfunded liabilities.

Washington is a national leader in pension reform. Benefit changes implemented in 1977 are now being copied by other states, our State Investment Board leads the pack in investment returns, and our open pension plans are funded at 118 percent. To keep our standing as a national leader, we need to adopt the discipline to pay down our unfunded liabilities without jeopardizing our healthy, open pension plans. Paying off the past and protecting the future will pay off in the long run.

## **Why Does the State Treasurer Care About Pensions?**

Pension policy is developed by the Pension Policy Committee, enacted by the Legislature, and implemented by the Governor and Department of Retirement Systems. Analytic evaluation of pension finance is provided by the Office of the State Actuary.

As State Treasurer, I am asked about the health of our state pension system every time I talk with credit rating agencies, investors and Wall Street analysts – and the accuracy of my answers is subject to the federal securities anti-fraud and disclosure laws. At the same time, I serve as the only statewide elected official on the State Investment Board, the agency responsible for investing pension assets. In both of these circumstances I have a fiduciary responsibility for the health of the pension system.

Prior to holding this office, I served for 10 years as a State Representative and was a member of one of the fiscal committees responsible for approving pension policy. As the state's chief financial officer I now have a perspective on pension issues that is informed by my prior role as an active participant in the pension decisions of the past decade.

## Constitutional Amendment Related to Pension Funding

Sec.	Proposed Language	Effect of Language
1	<p>To ensure more fiscal discipline in budgeting and to improve intergenerational equity for taxpayers, minimum standards shall apply to public pension plans administered by the state of Washington. Retirement benefits provided under these plans should, to the maximum extent possible, be funded over the working lives of plan members so that employer costs are paid by the taxpayers who receive the benefit of those members' service.</p> <p>This article applies to any defined benefit component of a public employee retirement plan administered by the state of Washington, except, as of the effective date of this section, the judges retirement fund, judicial retirement system, law enforcement officers' and firefighters' retirement system plan 1, and the volunteer firefighters' and reserve officers' relief and pension fund.</p>	<p>The intent and application section declares that the purpose of the amendment is to provide greater fiscal discipline and consistency in budgeting and funding of the state's retirement systems by improving intergenerational equity.</p> <p>This amendment does not apply to the retirement plans listed because of either their small size or current funded status.</p>
2	<p>For each state-administered pension plan that is open to new entrants, the legislature shall ensure that annual contributions are paid into the plan in amounts sufficient to fund at least eighty percent of the expected long-term annual cost of benefits under the plan, calculated as normal cost under the entry age normal actuarial cost method. These annual contributions shall remain in effect until the present value of fully projected benefits exceeds the actuarial value of assets for that plan as of the most recently published actuarial rate-setting valuation.</p>	<p>Contribution rates for open plans may never fall below 80% of entry age normal cost (EANC), unless the plan is fully funded, meaning the value of the pension assets is at least equal to the value of all the projected benefits for current members.</p> <p><i>The EANC rate represents the long-term expected contribution rate of the plan from a member's entry (or hire) date to their expected retirement. The EANC adjusts for future changes in plan benefits and assumptions.</i></p>
3	<p>Beginning July 1, 2015, the legislature shall ensure that annual employer contributions are made to plan 1 of the public employees' retirement system in amounts totaling no less than 5.25 percent of the salaries of all active members of the public employees' retirement system, public safety employees' retirement system, school employees' retirement system, and any newly-created retirement plan for public employees that were previously covered under the public employees' retirement system.</p> <p>Beginning September 1, 2015, the legislature shall ensure that annual employer contributions are made to plan 1 of the teachers' retirement system in amounts totaling no less than 8.00 percent of the salaries of all active members of the teachers' retirement system, and any newly-created retirement plan for teachers that were previously covered under the teachers' retirement system.</p>	<p>Fixed rates are established to systematically eliminate the unfunded actuarial accrued liability (UAAL) in the closed plans, PERS 1 and TRS 1.</p> <p><i>UAAL is the excess of the projected value of earned pension benefits over the current value of assets.</i></p>

Sec.	Proposed Language	Effect of Language
	<p>These annual employer contributions shall be used for the sole purpose of amortizing the unfunded actuarial accrued liability of the plan, and they exclude any amounts required to fund new benefit improvements that become law after the effective date of this section. These annual employer contributions shall remain in effect until the actuarial value of assets in the plan equals at least one hundred percent of the actuarial accrued liability.</p>	<p>New employer contributions do not include amounts required to fund new benefit improvements.</p>
4	<p>The legislature shall adopt policies to reasonably ensure that once the unfunded actuarial accrued liability in a closed plan is fully funded, it will not re-emerge. In addition, the legislature shall adopt policies that reasonably prevent the emergence of an unfunded actuarial accrued liability in any open plan, or in any plan that is closed to new entrants after the effective date of this section.</p>	<p>The Legislature is directed to adopt policies to prevent emergence of an unfunded actuarial accrued liability.</p>
5	<p>Legislative changes to actuarial methods or economic assumptions that result in lower expected long-term annual pension costs take effect two years following the date of enactment or at the beginning of the next fiscal biennium, whichever is later.</p>	<p>This section requires a two year waiting period for changes that lower long-term costs, and hence, contribution rates.</p>

DRAFT

# Draft Constitutional Amendment for Pension Funding

BE IT RESOLVED, BY THE SENATE AND HOUSE OF REPRESENTATIVES OF THE STATE OF WASHINGTON, IN LEGISLATIVE SESSION ASSEMBLED:

1 THAT, At the next general election to be held in this state the  
2 secretary of state shall submit to the qualified voters of the state  
3 for their approval and ratification, or rejection, an amendment to  
4 Article ... of the Constitution of the state of Washington **by adding**  
5 **new sections** to read as follows:  
6

7 Article . . . , Section 1. **Intent and Application.** To ensure  
8 more fiscal discipline in budgeting and to improve intergenerational  
9 equity for taxpayers, minimum standards shall apply to public pension  
10 plans administered by the state of Washington. Retirement benefits  
11 provided under these plans should, to the maximum extent possible, be  
12 funded over the working lives of plan members so that employer costs  
13 are paid by the taxpayers who receive the benefit of those members'  
14 service.

15 This article applies to any defined benefit component of a public  
16 employee retirement plan administered by the state of Washington,  
17 except, as of the effective date of this section, the judges  
18 retirement fund, judicial retirement system, law enforcement officers'  
19

1 and firefighters' retirement system plan 1, and the volunteer  
2 firefighters' and reserve officers' relief and pension fund.

3 Article . . ., Section 2. **Contributions, Open Plans.** For each  
4 state-administered pension plan that is open to new entrants, the  
5 legislature shall ensure that annual contributions are paid into the  
6 plan in amounts sufficient to fund at least eighty percent of the  
7 expected long-term annual cost of benefits under the plan, calculated  
8 as normal cost under the entry age normal actuarial cost method.  
9 These annual contributions shall remain in effect until the present  
10 value of fully projected benefits exceeds the actuarial value of  
11 assets for that plan as of the most recently published actuarial rate-  
12 setting valuation.

13 Article . . ., Section 3. **Contributions, Closed Plans.**  
14 Beginning July 1, 2015, the legislature shall ensure that annual  
15 employer contributions are made to plan 1 of the public employees'  
16 retirement system in amounts totaling no less than 5.25 percent of the  
17 salaries of all active members of the public employees' retirement  
18 system, public safety employees' retirement system, school employees'  
19 retirement system, and any newly-created retirement plan for public  
20 employees that were previously covered under the public employees'  
21 retirement system.

22 Beginning September 1, 2015, the legislature shall ensure that  
23 annual employer contributions are made to plan 1 of the teachers'  
24 retirement system in amounts totaling no less than 8.00 percent of the  
25 salaries of all active members of the teachers' retirement system, and  
26 any newly-created retirement plan for teachers that were previously  
27 covered under the teachers' retirement system.

28 These annual employer contributions shall be used for the sole  
29 purpose of amortizing the unfunded actuarial accrued liability of the  
30 plan, and they exclude any amounts required to fund new benefit  
31 improvements that become law after the effective date of this section.  
32 These annual employer contributions shall remain in effect until the  
33 actuarial value of assets in the plan equals at least one hundred  
34 percent of the actuarial accrued liability.

1 Article . . ., Section 4. **Policies to Prevent Future Unfunded**  
2 **Actuarial Accrued Liability.** The legislature shall adopt policies to  
3 reasonably ensure that once the unfunded actuarial accrued liability  
4 in a closed plan is fully funded, it will not re-emerge. In addition,  
5 the legislature shall adopt policies that reasonably prevent the  
6 emergence of an unfunded actuarial accrued liability in any open plan,  
7 or in any plan that is closed to new entrants after the effective date  
8 of this section.

9 Article . . ., Section 5. **Changing Actuarial Methods and**  
10 **Assumptions.** Legislative changes to actuarial methods or economic  
11 assumptions that result in lower expected long-term annual pension  
12 costs take effect two years following the date of enactment or at the  
13 beginning of the next fiscal biennium, whichever is later.

14 BE IT FURTHER RESOLVED, That this amendment is a single amendment  
15 within the meaning of Article XXIII, section 1 of the state  
16 Constitution.

17 The legislature finds that the changes contained in this amendment  
18 constitute a single integrated plan for managing risks in funding  
19 pensions for members and beneficiaries of the state-administered  
20 pension plans. If this amendment is held to be separate amendments,  
21 this joint resolution is void in its entirety and is of no further  
22 force and effect.

23 BE IT FURTHER RESOLVED, That the secretary of state shall cause  
24 notice of the foregoing constitutional amendment to be published at  
25 least four times during the four weeks next preceding the election in  
26 every legal newspaper in the state.

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