Select Committee on Pension Policy

Options for Managing Pension Risks: Constitutional Amendment

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Today's Work Session

- Requested by SCPP Executive Committee
  - Follow-up to risk management presentation at last SCPP meeting
- Purpose: explore constitutional options for managing risks
- Consider variety of approaches and views
  - Other states
  - Opportunity for public testimony

Protection Or Limitation?

- Depends on your point of view
- Some constitutional provisions protect individuals
- Some direct the branches of government to operate in a certain way
- Some limit the discretion of those in power

Constitutional Law Stands Above Legislative Law

- Constitution states broad principles of governance
  - Statutes specify details
  - Must be consistent with constitution
- Strongest form of law
  - If statute is in conflict, constitution prevails
  - Enforced by judicial branch
- Hard to change
  - Two-thirds vote of House and Senate
  - Majority of voters must ratify in next general election

How Specific Should Amendments Be?

- More specific = less flexibility
- Amendments can be in force for decades
  - Will the details stand the test of time?

Most States Favor Principles Over Specificity

- "Actuarial funding": Arizona, Virginia, and Texas
- "Sound actuarial funding": Georgia, Louisiana, Montana, New Hampshire, and South Carolina
- Annual funding for accrued retirement benefits: Michigan
- Six percent employee contribution: Oregon, Texas
- Sound actuarial funding of benefit increases: Florida, Maine, Mississippi, and South Carolina
- Actuary's statement of costs before benefits may be changed: Missouri
- Adequate funding of benefit increases and ability to change retirement plan to achieve actuarial soundness: New Mexico

Some States Are Very Specific

- Louisiana
  - Amortize liability for past service by a date certain (2029)
  - Legislature must provide employer portion of normal cost each year
  - Cost of living increases for retirees cannot cause an increase in the actuarially required contribution rate
- Maine
  - Fund benefit costs annually at 100 percent
  - Prohibit unfunded past liabilities except those from experience losses
    - Retire unfunded liability from experience losses in ten years
  - Retire unfunded actuarial accrued liability (UAAL) within a fixed period (31 years)

Being Specific Can Create Risks

- Maine amended state constitution in mid-1990s
  - Very specific and provides limited funding flexibility
    - Full annual funding
    - Target date for paying past unfunded liabilities
- Market plunge put Maine in a bind
  - Payoff deadlines hitting when markets low
  - Now pensions account for 10 percent of state budget and could rise to 15 percent

Washington's Constitution Mentions Pensions

- Pensions can be increased (Art. II, Sec. 25)
- Pension funds can be invested (Art. XXIX, Sec. 1)
- Funding and benefits policies are in statutes
  - Starting point for managing financial risks for pensions
- Should there be overriding policies in Washington's constitution?
  - Funding policies?
  - Benefits policies?
  - Investment policies?
  - Combination?

Possibilities For Managing Financial Risks

- Start with "big three" financial risks identified in 2010 Risk Assessment
  - Underfunding
  - Benefit improvements
  - Plan 1 legacy costs
- Menu of constitutional amendments
  - Not OSA recommendations
  - Includes a variety of proposals
  - Some are new
  - Some involve putting current law into constitution

Why Put Current Law Into Constitution?

- Statutes do not bind future legislatures
  - Can be changed during any session
- Constitutions bind current and future legislatures
  - Consistency over long term
- Pensions typically funded with long-term financing plan
  - Frequent changes can disrupt financing plan, adding risk
- Pros and cons to this approach

1. Risks From Underfunding

- Over past twenty years, largest pension plans funded at about 80 percent
  - Based on contributions needed under funding policies at the time
- Short-term funding policies contributed to underfunding
  - Gains captured early, losses deferred
- Several options relate to underfunding

1A. Mandate Annual Funding At 100 Percent

- Similar to Maine and Louisiana approaches
- High standard – can it be met each year?
  - Should exceptions be allowed?
    - Supermajority
    - Trigger
  - Will dedicated reserves be needed to comply?
    - Require "overfunding"
    - Allocate part of the existing constitutional rainy day fund to pensions
- Balancing act

1.B. Mandate Minimum Funding At 80 Percent

- Lines up with minimum rate floors currently in statute
- Less pressure for exceptions
- Not full funding but assures steady progress
  - Avoids ability of Legislature to change at any time
  - Avoids contribution rates dropping to artificially low levels during strong markets
- Does not prevent full funding
- "Overfunding" or dedicated reserves?
  - Not as pressing
  - May still be needed at times

1.C. Delay Changes To Methods And Assumptions

- Goal is to avoid short-term changes that lower expected long-term costs
  - Lowers contribution rates
  - Can lead to underfunding
- Examples, actuarial method changes
  - Suspend minimum contribution rates
  - Suspend cost of longer life spans
- Example, economic assumption change
  - Increase rate of return assumption
- Minimum two-year wait to become effective
  - Takes away incentives to get budget "savings" in upcoming biennium

2. Risk From New Benefit Improvements

- Largest plans have added new benefits each year
- Over past twenty years, 0.45 percent increase in liabilities each year
- Some of largest impacts have been from retroactive benefit increases
- Several options in this category

2.A. Flexible Or Non-Contractual Benefits

- Give Legislature clear authority to designate new benefit improvements as discretionary
  - Reduce, withhold, or repeal as needed
  - Example: gain-sharing
- Provides flexibility around funding
- Discretion can be broad or "contained"
  - Protect amounts already paid
  - Protect benefits for service already earned

2.B. Strict Funding Policy for Retroactive Benefits

- Goal is to avoid unfunded prior service costs
  - Previous contributions did not anticipate the new cost
  - Can add significant unfunded liability to a pension plan
- Require that new retroactive benefit improvements be funded over a short period of time
  - One year or a biennium
  - Practical effect is that funds must be available to pay the cost
  - Avoids collecting more payments in future

2.C. and D. Thresholds and Procedures

- Limit or prohibit new benefits if plan is unhealthy
  - Set funded status threshold for health
  - Eighty percent common in private sector
- Add procedures to require more scrutiny
  - Supermajority
  - Voter approval
- Both options require careful balancing
- Must stand test of time

3. Risk From Plan 1 Legacy Costs

- PERS 1 and TRS 1 UAAL at about $7 billion
  - June 30, 2009, Actuarial Valuation Report
- Driving large increases in employer contribution rates
- Creating significant affordability challenges
- Two options in this category

3.A. Pay Off Plan 1 Legacy Costs

- Mandate minimum funding rates starting in 2015
  - Consistent with rates in statute for Plan 1 funding method
  - Assures steady progress
  - Flexibility to use any funding source
- Make large minimum payments each year until unfunded liability is gone
  - Equivalent to 5.25 percent of payroll for PERS 1 and 8.00 percent for TRS 1
  - No firm pay-off date to limit risk of "spiking" contributions
- Becomes moot when legacy costs are gone

3.B. Protect Closed Plans

- Direct Legislature to adopt policies to prevent PERS/TRS 1 UAAL from re-emerging once paid off
- Direct Legislature to adopt policies to prevent UAAL from emerging in plan closed after date of amendment
- Legislature would have flexibility to implement the principles
  - Funding policy
  - Investment policy
  - Benefits policy
  - Combination

Recap: Manage Underfunding

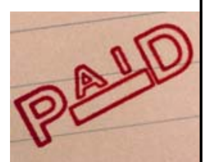
- A. Mandate annual funding at 100 percent
  - Flexibility?
  - Reserves?
- B. Mandate annual funding at 80 percent
- C. Establish waiting period for changes to methods and assumptions

Recap: Manage New Benefit Improvements

- A. Flexible or non-contractual benefits
  - Reduce, withhold, repeal
  - Protect benefits already paid or earned
- B. Strict funding policy for retroactive benefit improvements
- C. Limit or prevent benefit improvements to unhealthy plans
- D. Supermajority or voter approval

Recap: Manage Legacy Costs

- A. Pay minimum amounts each year
  - Any funding source
  - Continue until fully paid
- B. Direct Legislature to adopt policies
  - Keep legacy costs from coming back
  - Prevent new legacy costs



Wide Range of Options Available

- Some are general principles, some very precise
- Some substantive, some procedural
- Some consistent with past practices, some not
- Some require balancing competing interests

Possible Next Steps

- Take no further action
- Recommend further study
- Develop an SCPP recommendation
  - Pick from options outlined today (see handout)
  - Develop one or more new options
- Study or endorse another proposal
- Focus on other strategies for managing pension risks