LEGISLATIVE EDUCATION STUDY COMMITTEE
BILL ANALYSIS

Bill Number: SB 26 **51st Legislature, 1st Session, 2013**

Tracking Number: .190476.2

Short Title: Supplemental Retirement Contributions

Sponsor(s): Senator George K. Munoz

Analyst: Ian Kleats **Date: February 4, 2013**

FOR THE INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

Bill Summary:

SB 26 amends multiple sections of the *Public Employees Retirement Act*, the *Magistrates Retirement Act,* and the *Judicial Retirement Act* authorizing the Public Employees Retirement Association (PERA) to:

- determine and impose a supplemental employee contribution rate not greater than 35 percent of the base employee contribution rate; and
- determine and enact an annual cost-of-living adjustment (COLA) for pension benefits that is no less than zero percent, but no greater than 3.0 percent.

The bill also details the following factors to be considered by the PERA Board when determining the supplemental employer contribution rates:

- the PERA Board shall consider the solvency of the coverage plan and whether the plan is projected to be 90 percent funded within 30 years;
- other relevant factors as determined by the PERA Board; and
- whether the supplemental contribution will enhance and preserve the actuarial soundness of the retirement plan.

Finally SB 26 outlines the following factors to be considered by the PERA Board when determining the annual COLA:

- the PERA Board shall consider the solvency of the coverage plan and whether the plan is projected to be 90 percent funded within 30 years;
- other relevant factors as determined by the PERA Board;
- the change in consumer price index (CPI) for the previous 12 months; and
- whether the COLA will enhance and preserve the actuarial soundness of the retirement plan.

The effective date of the provisions of this bill is July 1, 2013.

<u>Fiscal Impact</u>:

SB 26 proposes possible employee, rather than employer, contribution increases, and as such, it carries neither an appropriation nor a revenue impact.

<u>Fiscal Issues</u>:

During the interim, testimony to the LESC by Legislative Council Service staff for the interim Investments and Pensions Oversight Committee (IPOC), indicated:

- the industry standard for actuarial soundness of a pension fund suggests that any funded level below 80 percent carries increased risks; and
- based on accounting and financial statement requirements from the Governmental Accounting Standards Board (GASB), ratings agencies could begin downgrading the bond rating of governments unless steps are taken to improve actuarial standing of public pensions.

As PERA notes in its analysis, SB 26 would result in significant improvement to the actuarial soundness of its funds.

<u>Substantive Issues</u>:

Possible Criteria to Consider for Automatic Policy Rules

Several criteria could be considered when evaluating the automatic policy rules proposed by SB 26. These criteria include:

- transparency;
- consistency; and
- effectiveness.

Transparency

Transparency describes how an employee, an affiliated employer, or even someone unrelated to the PERA system can view and understand the mechanism through which the PERA Board determines the supplemental contribution rates and the COLA. Because PERA Board meetings are subject to the *Open Meetings Act*, individuals would have access to the deliberations of the Board.

However, SB 26 does not define a mechanism for those determinations, allowing the Board broad discretion in its decisions. Because the language allows the Board to make an arbitrary, though not capricious, determination, it might be considered that SB 26 does not fulfill the principle of transparency. This could be addressed through an amendment requiring that the Board enact rules detailing the methods used in their determination, and that the Board make its determination in accordance with those rules.

Consistency

Consistency refers to both the predictability and stability of a policy rule. It could be considered important for employees and retirees to have an expectation of either their take-home pay or their level of pension benefit will be in the near-term. This principle also implies that it might be detrimental if the supplemental contribution rate were to change sporadically from one year to the next.

The provisions of SB 26 ensure that the supplemental rates and the COLA is determined no more than once per year, which partially addresses concerns of consistency. On the other hand, SB 26 ties those rates to PERA's 90 percent funding period, which is subject to volatile swings due to fluctuations in the stock market.

Additionally, the 90 percent funding period is heavily dependent upon assumptions and methods used in PERA's actuarial valuations. This leaves open the possibility that the PERA Board might change those methods and assumptions between years to continue (or discontinue) supplemental contribution rates, or to decrease (or increase) the COLA in any given year.

Effectiveness

Effectiveness of automatic policy rules could consider the power and precision of the policy instruments used. There can be trade-offs between those two factors. For instance, the COLA rate, especially for PERA, is an extremely powerful instrument with which to target a specific funded ratio, but as a result, small changes to the COLA rate could result in large swings in the funding period or the funded ratio meaning that it could be less precise. Changes to the contribution rates, on the other hand, might not result in a dramatic shift in the funded status, but could be calibrated to "fine-tune" the approach to an actuarial funding target.

SB 26 appears to address the principle of effectiveness by allowing both instruments, the COLA and the contribution rates, to be used as tools in targeting a 90 percent funding period of 30 years. However, the provisions do not explicitly detail how the two instruments might interact. As a result, the PERA Board might have to exercise some discretion to ensure their effective use.

Economic Implications

According to the PERA Comprehensive Annual Financial Report for FY 12, PERA's annual covered payroll for FY 12 was approximately $1.994 billion. Based on that figure:

- LESC staff estimate, using a weighted-average based on current active membership of the possible increase to current contributions rates, the average supplemental employee contribution rate could be up to 3.31 percent;
- the supplemental employee contribution rate could result in reduced pre-tax income of $66.0 million per year relative to current law; and
- this estimate does not consider possible payroll growth, which could further increase the total economic impact.

The possible contractionary impact of the increased contribution rates could be partially offset if PERA were to make investments of those contributions in companies that operate wholly within the state, but the current composition of PERA investments suggests a significant portion of investments are made out of the state.

Dr. Dean Baker[1], in written testimony provided to a joint session of the Senate Judiciary and the House Labor and Human Relations Committees during the 2013 legislative session, stated that "[i]f we overfund our pensions by having [higher] tax rates than would otherwise be necessary in the present, then we will be causing unnecessary losses of economic output."

Differences between Funded Ratio and Solvency

To put Dr. Baker's statement in context, it is important to make the distinction between funded ratio and plan solvency which, although related, should not be confused for the same concept.

Funded ratio is:

- the actuarial value of assets ("what we have today") divided by the actuarially accrued liability ("what we might owe in the future for today's workers");
- dependent on accrual basis accounting ("putting future expenses or income on today's books"); and
- dependent on actuarial methods ("statistically weighting by possibilities").

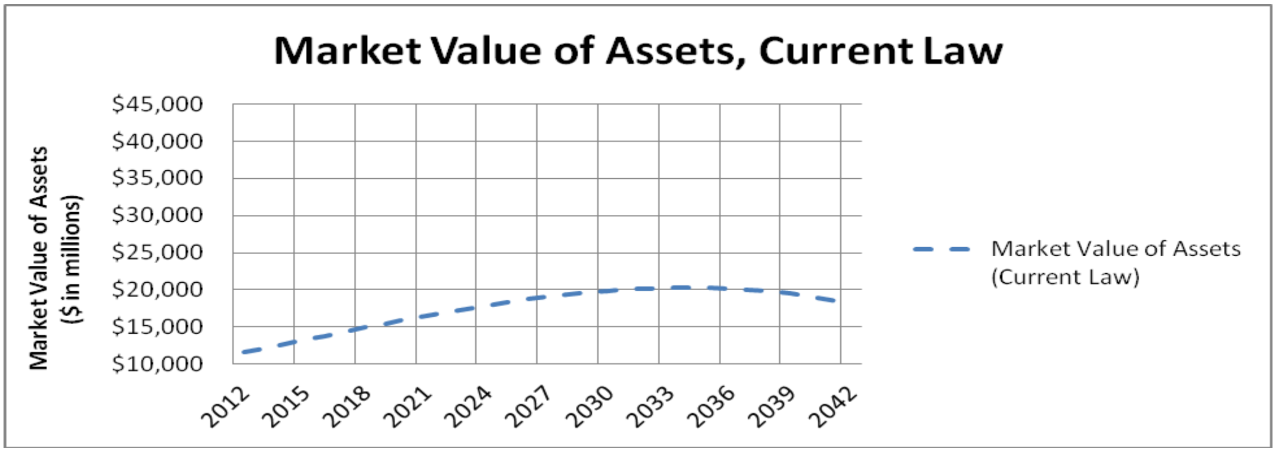
Solvency is:

- the ability to meet maturing obligations as they come due; or
- "being able to pay our bills today for what we promised yesterday."

Consequently, it is entirely possible for the state to meet its pension obligations through the Educational Retirement Board, that is to say the fund could remain solvent, indefinitely into the future even with a funded ratio persistently less than 100 percent. Programs with this feature could be characterized as partially- or fully-pay-as-you-go.

A graph helpful in showing when the fund is going to be insolvent, or in other words, when PERA is no longer going to be able to pay its bills, is the projection of market value of assets. The graph below illustrates the amount PERA has available to pay out benefits and other costs in future periods. As such, when net assets drop below $0.00, the fund would be insolvent, and when they display a long-term downward trend, it would indicate that potential corrective action might be necessary to prevent insolvency.

[1] Dr. Dean Baker is co-director of the Center for Economic and Policy Research in Washington, DC. He previously worked as a senior economist at the Economic Policy Institute and an assistant professor at Bucknell University. He has also worked as a consultant for the World Bank, the Joint Economic Committee of the U.S. Congress, and the OECD's Trade Union Advisory Council.



Source: PERA

Under current law, the PERA fund's market value of assets would peak in calendar year 2034 and thereafter start declining. Although not shown on this graph, the market value of assets would continue to decrease until approximately 2055 when the fund would become insolvent. The measures proposed by SB 26 could prevent insolvency, but without actuarial projections from PERA, it is impossible that quantify the impact of its provisions.

The provisions of SB 26, in addition to improving the fund status, are structured in such a way to target a funded ratio of 90 percent within thirty years. Upon reaching that 90 percent funding point, it is unclear whether the base employee contribution rates would result in a funded ratio of greater than 100 percent, which would provide little more protection against insolvency than a ratio of 100 percent or even 90 percent. A funded ratio exceeding 100 percent could be considered overfunding, which according to Dr. Baker's testimony, could cause unnecessary loss of economic output.

Background:

SB 26 has been endorsed by the interim Investment and Pension Oversight Committee.

The Attachment, "PERA Member Contribution Rates," details the employee and employer contribution rates that will prevail on July 1, 2013 under current law. FY 13 is the final year of a 1.5 percent employee-employer contribution swap enacted by Laws 2009, Ch. 127, which increased the employee rate while decreasing the employer rate by the same amount in an effort to improve the fiscal position of the State.

Further solvency action through Laws 2011, Ch. 178 resulted in an additional employee-employer contribution swap of 1.75 percent. The duration of that swap was contingent on revenue forecasts not exceeding budgeted amounts by a certain amount, and year-end reserve levels under 5 percent of appropriations. At the end of FY 12, the contingency conditions were not fulfilled, resulting in a termination of the additional 1.75 percent swap beginning FY 13.

Committee Referrals:

SJC, SFC

Related Bills:

SB 25 *Judicial Retirement Changes*
SB 27 *Public Employee Retirement Changes*
SB 71 *Retiree Health Care Contributions*
SB 86 *Public Employee Average Salary Calculations*
SB 114 *Legislative Retirement Qualification*
SB 121 *Law Enforcement Returning to Work*
SB 168 *Public Safety Officers Returning to Work*
HB 95 *Judicial Retirement Changes*
HB 147 *Public Employees Returning to Work Retirement*
HB 169 *Judicial Retirement Contributions*

Educational Retirement Legislation

SB 115 *Educational Retirement Changes*
HB 64 *Educational Retirement Changes*
HB 96 *Educational Retirement Sick Leave*

Maximum Possible PERA Member Contribution Rates
Current Law vs. SB 26

ATTACHMENT

	Current Law[1]			SB 26		
	Employee	Employer	Total	Employee	Employer	Total
State General						
Plan 3	7.42%	16.59%	24.01%	10.02%	16.59%	26.61%
State Hazardous Duty						
Plan 2	4.78%	25.72%	30.50%	6.45%	25.72%	32.17%
Municipal General						
Plan 1	7.00%	7.00%	14.00%	9.45%	7.00%	16.45%
Plan 2	9.15%	9.15%	18.30%	12.35%	9.15%	21.50%
Plan 3	13.15%	9.15%	22.30%	17.75%	9.15%	26.90%
Plan 4	15.65%	11.65%	27.30%	21.13%	11.65%	32.78%
Municipal Police						
Plan 1	7.00%	10.00%	17.00%	9.45%	10.00%	19.45%
Plan 2	7.00%	15.00%	22.00%	9.45%	15.00%	24.45%
Plan 3	7.00%	18.50%	25.50%	9.45%	18.50%	27.95%
Plan 4	12.35%	18.50%	30.85%	16.67%	18.50%	35.17%
Plan 5	16.30%	18.50%	34.80%	22.01%	18.50%	40.51%
Municipal Fire						
Plan 1	8.00%	11.00%	19.00%	10.80%	11.00%	21.80%
Plan 2	8.00%	17.50%	25.50%	10.80%	17.50%	28.30%
Plan 3	8.00%	21.25%	29.25%	10.80%	21.25%	32.05%
Plan 4	12.80%	21.25%	34.05%	17.28%	21.25%	38.53%
Plan 5	16.20%	21.25%	37.45%	21.87%	21.25%	43.12%
Municipal Detention Officer						
Plan 1	16.65%	16.65%	33.30%	22.48%	18.15%	40.63%

[1] Current law as of July 1, 2013.