



# Pension Funding Reform for Washington State

Washington State Treasurer

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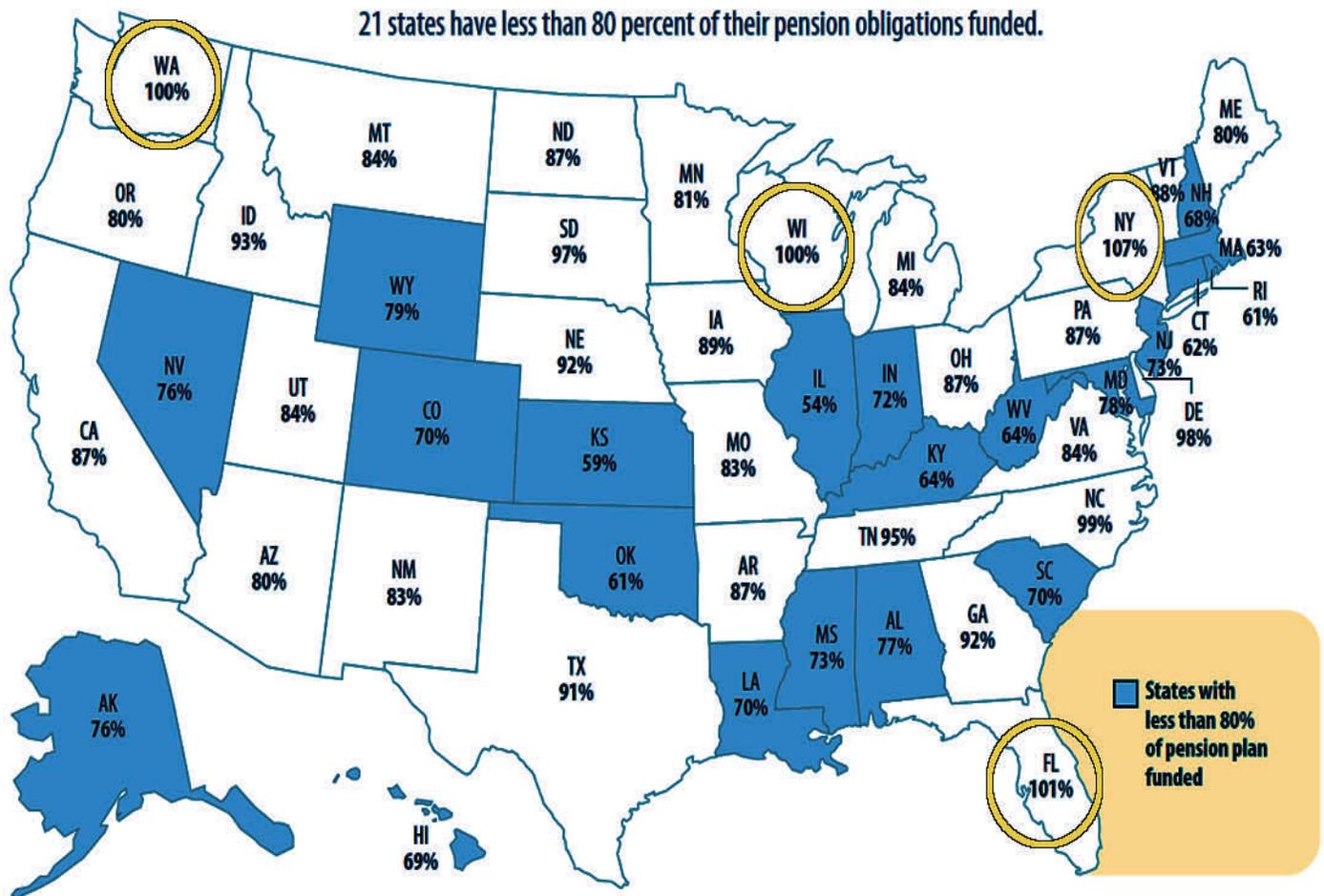
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The 2010 Risk Assessment completed recently by the State Actuary at the direction of the State Select Committee on Pension Policy calls for sustained pension contributions from employers and employees that when effectively invested will properly pay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

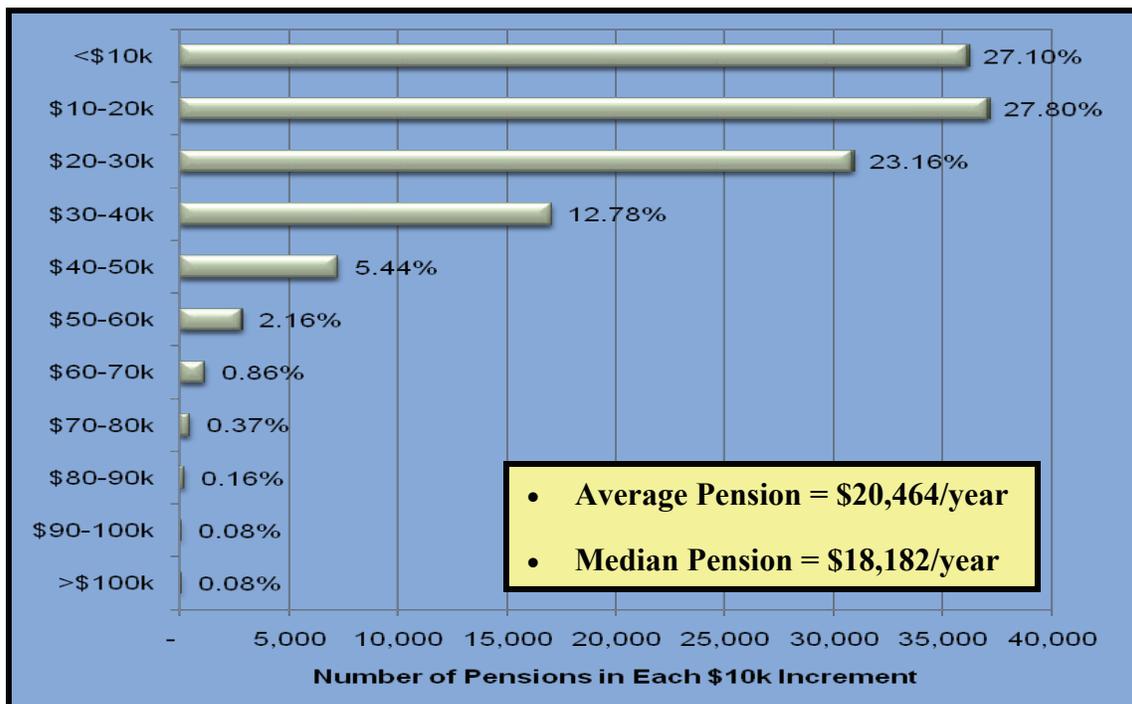
to 1977. The pension benefits owed to these public servants are constitutionally protected by contract, and state and local governments (including school districts) must pay them.

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-



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

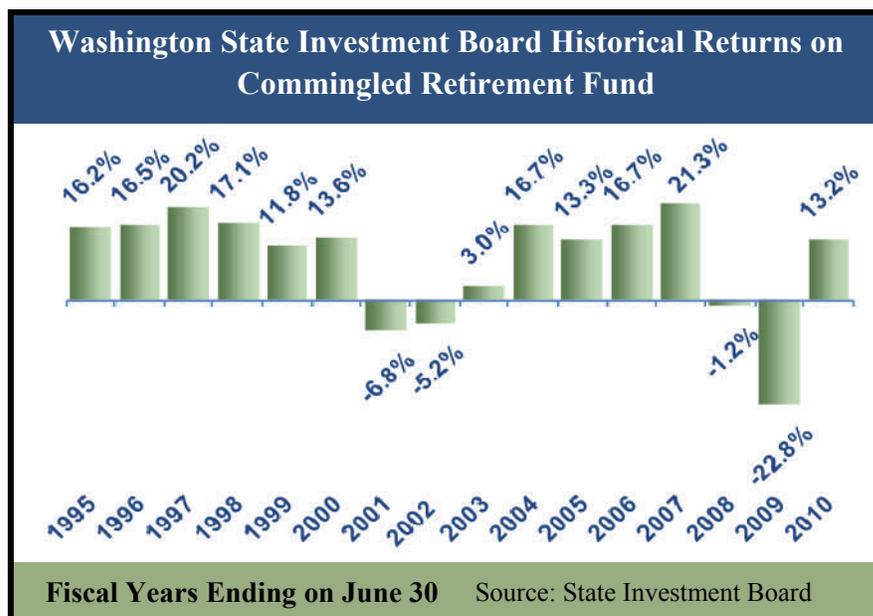
7.5 percent of salary and a guaranteed annual return of at least 5 percent per year (*State Retirement Systems Defined Contribution Plans, NCSL 2009*).

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.

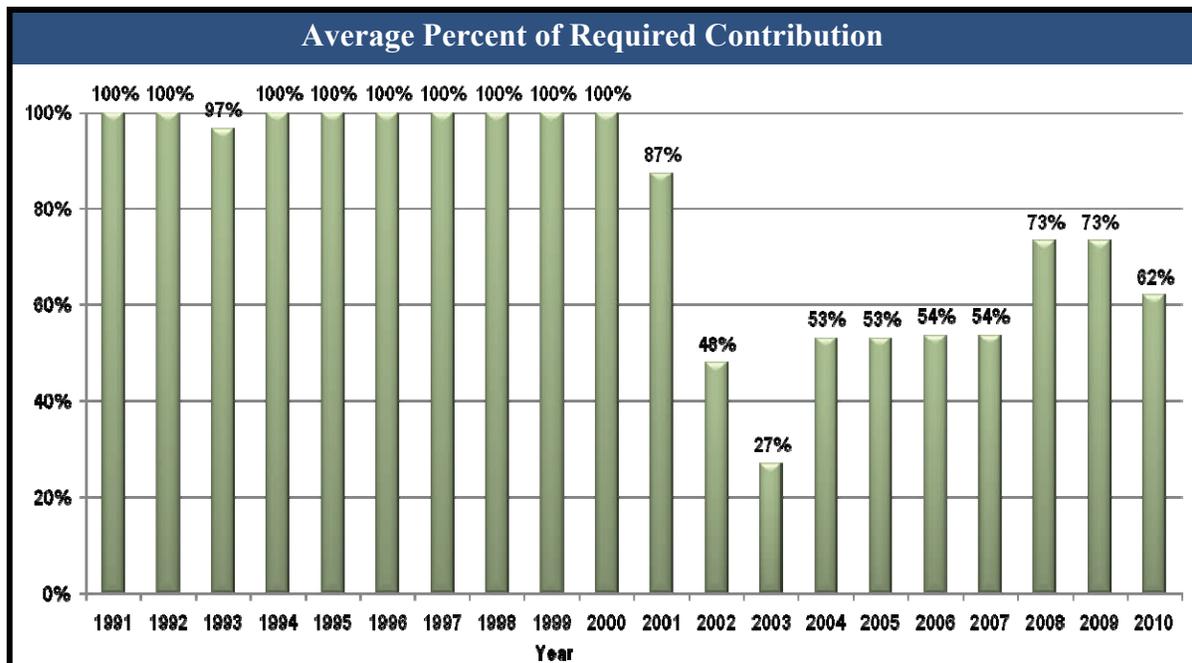
While there may be some legitimate concern about the ability of future returns to equal past performance in this new financial reality, it is not clear that there is another investment model that would out-perform the one in place. Some strategies might produce less volatility, but in doing so they would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