Plan 1 Unfunded Liability

Background

The Unfunded Actuarial Accrued Liability for the PERS and TRS Plans 1 (Plan 1 UAAL) continues to be a significant obligation for all employers in PERS, TRS, SERS, and (effective July 1, 2006), PSERS. Payments for this obligation were suspended during the previous and current biennia. Regular UAAL payments are scheduled to resume in the 2007-2009 biennium.

Committee Activity

Presentations:

July 19, 2005 – Full Committee
August 23, 2005 – Full Committee

Plan 1 Unfunded Liability Subgroup:

October 3, 2005 – Subgroup Meeting
October 27, 2005 – Subgroup Meeting
November 15, 2005 – Subgroup Recommendation to Full Committee

Proposal:

December 13, 2005 – Full Committee

Recommendation to Legislature

Reinstate contribution rates for the Plan 1 UAAL beginning July 1, 2006, using a three-year phase-in. (Proposed legislation is under this tab.) Establish minimum contribution rates for the Plan 1 UAAL beginning July 1, 2009. (See Tab 3, Contribution Rate Floors.)

Staff Contact

Laura Harper, Senior Research Analyst, Legal
360.786.6145; harper.laura@leg.wa.gov

Select Committee on Pension Policy

Plan 1 Unfunded Liability

(December 21, 2005)

Issue

The Unfunded Actuarial Accrued Liability for the PERS and TRS Plans 1 (Plan 1 UAAL) continues to be a significant obligation for all employers in PERS, TRS, SERS and (effective July 1, 2006), PSERS. The current funding methodology and policies for addressing the Plan 1 UAAL are contributing to courses of action that are causing this unfunded liability to grow. As the Plan 1 UAAL grows, it becomes an increasingly larger portion of employer contribution rates - rates which are already projected to climb steeply in the future. This report will examine the Plan 1 UAAL and explore options for managing it in the future.

Staff

Laura C. Harper, Senior Research Analyst/Legal
360-586-7616

Members Impacted

Members are not directly impacted by the Plan 1 UAAL, as their contribution rates do not include payments for this unfunded liability. However, to the extent that the Plan 1 UAAL affects benefit security and future benefit improvements in the affected plans, there is an effect on members.

Current Situation

Current Funding Methodology

The current funding policy for paying the UAAL is twofold: 1) spread the cost out over time - that is, pay the UAAL over an amortization period that extends through June 30, 2024; and, 2) spread the cost over more employers - that is all PERS, TRS, SERS, and (starting July 1, 2006), PSERS employers of members of all the plans within those systems (Plans 1, 2 and 3), including projected new entrants for the systems in the future.

Magnitude of UAAL

According to the 2003 Actuarial Valuation Report (AVR), the PERS, and TRS Plans 1 have a combined UAAL of approximately **$4 billion**, with the UAAL for PERS 1 at $2.620 billion and the UAAL for TRS 1 at $1.416 billion. LEOFF 1 is currently running a negative UAAL, which is also referred to as a "surplus." The amount of the UAAL will vary from one actuarial valuation to the next. The most significant factor in this variation is investment returns.

Based on the most recent actuarial valuation, the employer contribution rates (expressed as a level percentage of pay) and schedule of payments required in the 2005-2007 biennium to amortize the Plan 1 UAAL are:

System	UAAL rate* 2005-2007	GF-S Contributions**	Total Employer Contributions
PERS	2.10%	$67.6	$338.0
TRS* **	2.80%	139.5	231.7
SERS	2.10%	23.3	59.7
Total		$230.4	$629.4

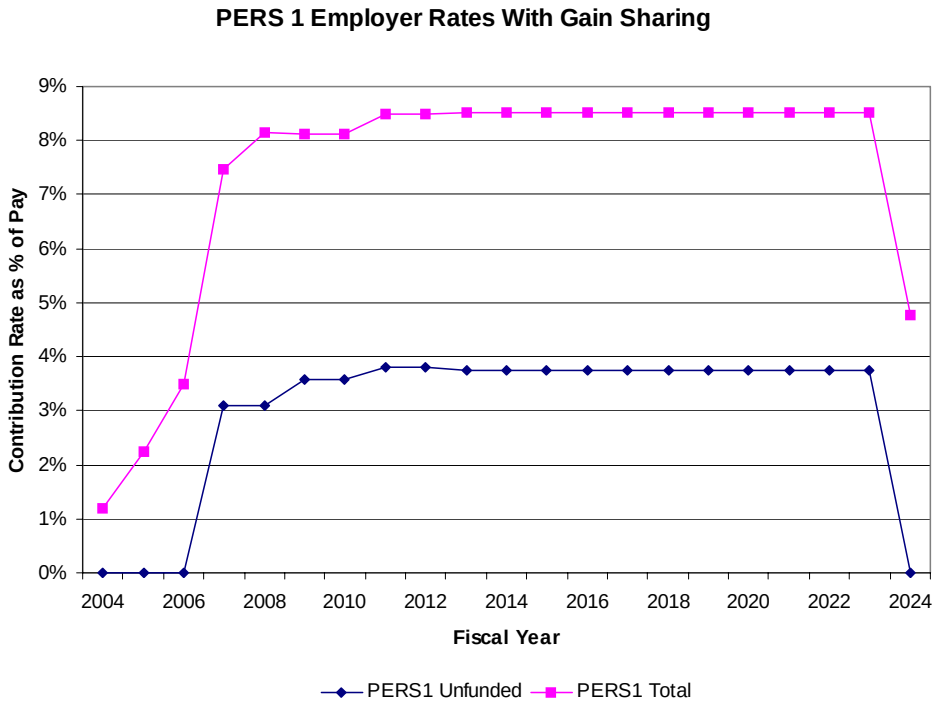
** Rates and funds include the cost of future gain-sharing benefits. Rates in effect for two-year period beginning July 1, 2005 for PERS, September 1, 2005 for TRS and SERS.*
*** Dollars are in millions.*
**** Includes an additional 0.01 percent for the non-automatic post-retirement benefit increase provided under Chapter 85, Laws of 2004.*

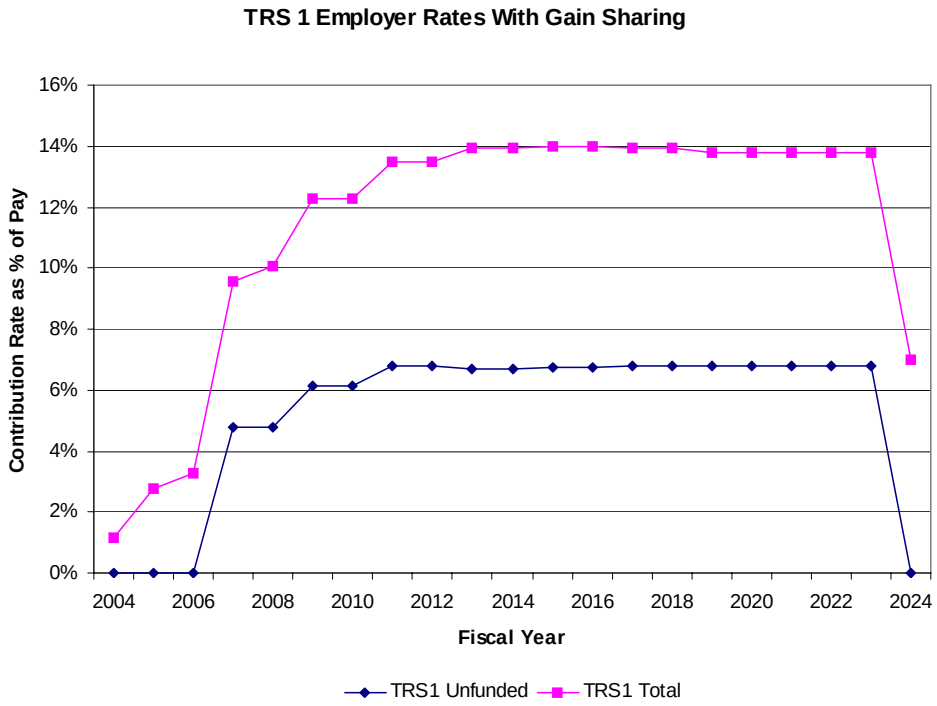
Role of Plan 1 UAAL in Projected Employer Contribution Rates

The Plan 1 UAAL payments represent a significant component of the required employer contribution rates. Currently, employer and state contribution rates must be the “level” percentages of pay that are required not only to fully amortize the unfunded liability in PERS 1 and TRS 1, but also to fully fund the Plans 2/3.

Contribution rates for all affected systems are projected to increase significantly over the next several biennia. By the 2009 fiscal year it will cost employers more than 6 percent of payroll just to fund the TRS 1 UAAL alone. In addition, basic contribution rates must cover the normal cost of benefits, meaning that employer rates are projected to climb to ultimate levels of about 8 percent for PERS, 14 percent for TRS and 11 percent for SERS.

The following graphs illustrate the role of the Plan 1 UAAL in projected basic employer contribution rates.


PERS 1 Employer Rates With Gain Sharing
Contribution Rate as % of Pay
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
2024
Fiscal Year
PERS1 Unfunded
PERS1 Total



Current Status of Actuarially Required Payments

The legislature suspended payments for the UAAL in the current biennium (2005-2007). Payments were also suspended during the previous biennium (2003-2005). Absent this legislation, regular UAAL payments are scheduled to resume in the upcoming biennium (2007-2009).

There will be a long-term increase in the UAAL contribution rates as a result of this biennium's two-year suspension. The PERS UAAL rate, payable by PERS, SERS, and PSERS employers, will increase 0.25 percent and the TRS UAAL rate will increase 0.30 percent beginning in the 2007-2009 biennium. The fiscal budget determinations below illustrate the cost in dollars of suspending the Plan 1 UAAL in the current biennium.

Change in Plan 1 UAAL Rates from Suspension

Biennium	PERS	TRS	SERS
2005-2007	(1.70%)	(2.00%)	(1.70%)
2007-2009 & thereafter	0.25%	0.30%	0.25%

Fiscal Budget Determinations for Suspending UAAL Payments in 2005-2007:

As a result of the higher (lower) required contribution rate, the increase (decrease) in funding expenditures is projected to be:

Costs (in Millions):	**PERS**	**TRS**	**SERS**	**Total**
2005-2007				
State:				
General Fund	($54.7)	($99.6)	($18.9)	($173.2)
Non-General Fund	($90.3)	$0.0	$0.0	($90.3)
Total State	**($145.0)**	**($99.6)**	**($18.9)**	**($263.5)**
Local Government	($128.6)	($65.9)	($29.5)	($224.0)
Total Employer	($273.6)	($165.5)	($48.4)	($487.5)
Total Employee	$0.0	$0.0	$0.0	$0.0
2007-2009				
State:				
General Fund	$9.0	$18.1	$1.8	$28.9
Non-General Fund	$14.8	$0.0	$0.0	$14.8
Total State	**$23.8**	**$18.1**	**$1.8**	**$43.7**
Local Government	$21.2	$9.0	$2.5	$32.7
Total Employer	$45.0	$27.1	$4.3	$76.4
Total Employee	$0.0	$0.0	$0.0	$0.0
2005-2030				
State:				
General Fund	$66.8	$141.3	$25.4	$233.5
Non-General Fund	$109.9	$0.0	$0.0	$109.9
Total State	**$176.7**	**$141.3**	**$25.4**	**$343.4**
Local Government	$156.7	$54.4	$36.9	$248.0
Total Employer	$333.4	$195.7	$62.3	$591.4
Total Employee	$0.0	$0.0	$0.0	$0.0

Another way of examining the cost to all employers of suspending the Plan 1 UAAL payment in the current biennium is to use a "Truth in Lending" format that discloses the amount financed, the applicable interest percentage rate, and the dollars paid over the life of the "loan."

TRUTH-IN-LENDING DISCLOSURE FOR SUSPENSION OF PLAN 1 UAAL PAYMENT IN THE CURRENT BIENNIUM (2005-2007)

Annual Percentage Rate	Finance Charge	Amount Financed	Total of Payments
The cost of the "credit" as a yearly rate	The dollar amount the credit will cost all employers	The amount of credit provided (i.e. amount suspended in current biennium)	The amount all employers will have paid after making all the scheduled payments
8%	**$591.4 million**	**$487.5 million**	**$1.0789 billion**

History

How did PERS and TRS 1, which were closed in 1977, accumulate such a large UAAL? A combination of under-funding coupled with significant benefit improvements has, over time, led to this unfunded liability. Market returns have also played a role. Finally, changes in funding policy have steered the system toward contribution rate reductions which have amplified the rate increases that ultimately must follow.

Changes in Plan 1 UAAL Over Time

The following table is a ten-year history of the Plan 1 UAAL for PERS and TRS. This table illustrates how the Plan 1 UAAL can ebb and flow over time.

AVR*	PERS 1	TRS 1	TOTAL**
1994	$2,684	$2,720	$5,404
1995	2,993	2,850	5,843
1996	2,640	2,593	5,233
1997	1,659	1,547	3,206
1998	1,506	1,234	2,740
1999	809	663	1,472
2000	227	4	231
2001	301	(22)	279
2002	1,366	574	1,940
2003	2,620	1,416	4,036

* *Actuarial Valuation Report*

** *Dollars in millions*

Under-Funding

Prior to enactment of the Pension Funding Reform Act in 1989, contributions to the Plans 1 were made on an ad hoc basis. For the nine biennia (18 years) extending from 1973 through 1991, the full funding requirements of PERS, TRS, and LEOFF were satisfied by the legislature only once. Actual contributions ranged from a low of 60 percent of the required amount in 1973-75 to a high of 95 percent in 1979-81.

After passage of the Pension Funding Reform Act, the legislature embarked upon a 12-year period (1991-2003) of funding 100 percent of the actuarially required contributions. However, in the past and current biennia the legislature again created a gap between the actuarially required contributions and the amounts actually appropriated for expenditure, funding the retirement systems at the 70 percent level for 2003-2005.

Plan 1 Benefit Improvements

In 1972 for PERS and 1973 for TRS, the benefit formula for the Plans 1 was increased from a 1 percent to a 2 percent formula. There is no fiscal note to access for the legislation effecting this benefit change, as the Office of the State Actuary did not exist at that time. However, one can assume that this benefit improvement doubled the cost of retirement benefits in the Plans 1.

In 1989, the same year that the Pension Reform Act was enacted, the Plan 1 Age-65 COLA also became law. This was the first *automatic* cost-of-living adjustment granted in the PERS/TRS systems. Another significant benefit improvement occurred in 1995, when the Uniform COLA design replaced the Plan 1 Age 65 COLA.

The Uniform increase is a dollar amount, which increases by at least 3 percent each year, multiplied by the members' total years of service; the product is then added to each member's monthly retirement benefit each year. As of July 1, 2005, the Uniform Increase Amount is $1.25. A retiree who was at least age 66 at retirement with 30 years of service will receive a monthly increase of $37.50. In 1995, enactment of the Uniform COLA legislation was projected to increase the PERS and TRS Plan 1 unfunded liability by roughly $300 million (present value at 1995), and the 25-year "total state" cost of the benefit was estimated at $612 million.

Other Plan 1 benefit improvements have included early retirement windows in 1980, 1982, 1992, and 1993. Early retirement windows typically provide short-term salary savings but add long-term liability to the pension system, as the retirement benefits for those retiring early are received over a longer period of time.

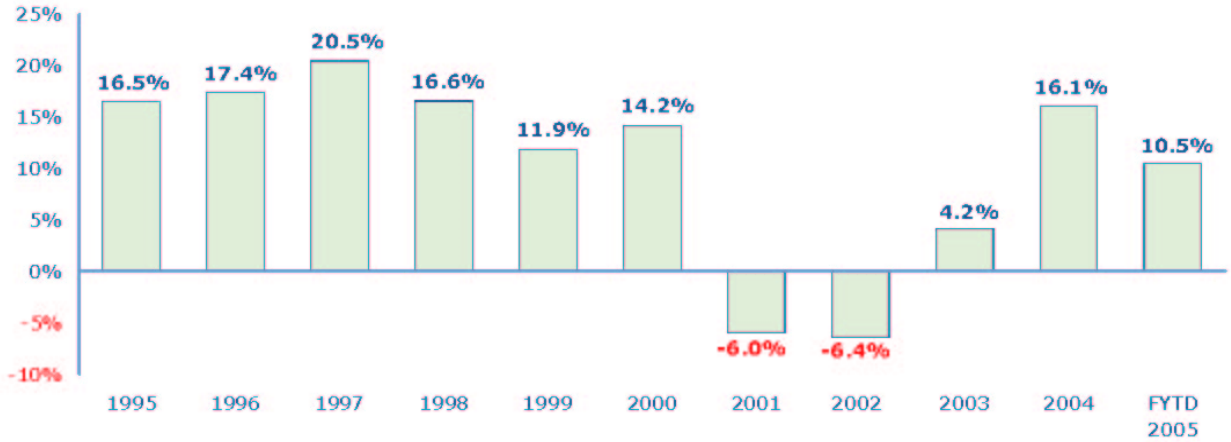
Also, in 1998, Plan 1 gain-sharing was enacted. For the PERS and TRS Plans 1, one-half of the gain-sharing amounts allocated in 1998 and 2000 resulted in increases to the "Annual Increase Amount" used in calculating the Uniform COLA. These benefit increases were permanent with a cost totaling $924 million. The other half of the Plan 1 gain-sharing allocations - another $924 million - was used to help draw down the Plan 1 amortization date. In 2000, as the result of gain-sharing, the Plan 1 UAAL payoff date was moved back to 2016. In 2001, however, the Plan 1 UAAL payoff date was extended back out to 2024, the same as it was prior to gain-sharing.

Market Returns

Market returns have also played a significant role in the magnitude and movement of the Plan 1 UAAL over time. When market experience is more favorable than the actuarial assumed rate of investment returns (8 percent for the Washington State Retirement Systems), unfunded plan liabilities are reduced. When market experience is less favorable, unfunded plan liabilities increase.

The State Investment Board reports the following annual performance for assets under management over the past ten years:

SIB Annual Performance - Fiscal Years End June 30



Changes in Funding Policy

Finally, changes in funding policy over the last 12 years have contributed to the movement and magnitude of the Plan 1 UAAL over time. Due to circumstances in the market, these changes steered the system toward contribution rate reductions in each instance, leading to both premature recognition of investment gains and also to delayed recognition of investment losses. The changes also amplified the future rate increases that must ultimately follow to meet the funding obligations by the required payoff date.

The funding policy changes that contributed to increasing the UAAL in the later years of the amortization schedule (i.e. "back-loading" the payoff) included:

- 1993 change from a six-year contribution rate setting cycle to a two-year cycle;
- 2001 change from a three-year to a four-year smoothing period;
- 2003 change from a four-year up to an eight-year smoothing period; and,
- Annual adoption of contribution rate decreases in certain "off-cycle" years.

To summarize, the history of the Plan 1 UAAL shows a multitude of factors contributing to its fluctuating size over time. These include under-funding, benefit improvements, investment returns and changes in funding policy. It would be useful to be able to break the UAAL into a convenient "pie chart" showing how much of today's unfunded liability it is attributable to each factor. However, this has not been possible because of the complexity of the factors and the difficulty in quantifying each one of them in today's dollars (e.g. costs in 1995 are not comparable to costs today). In any event, this report illustrates that the Plan 1 UAAL is not a fixed amount. Instead it fluctuates in every funding cycle and thus is a "moving target."

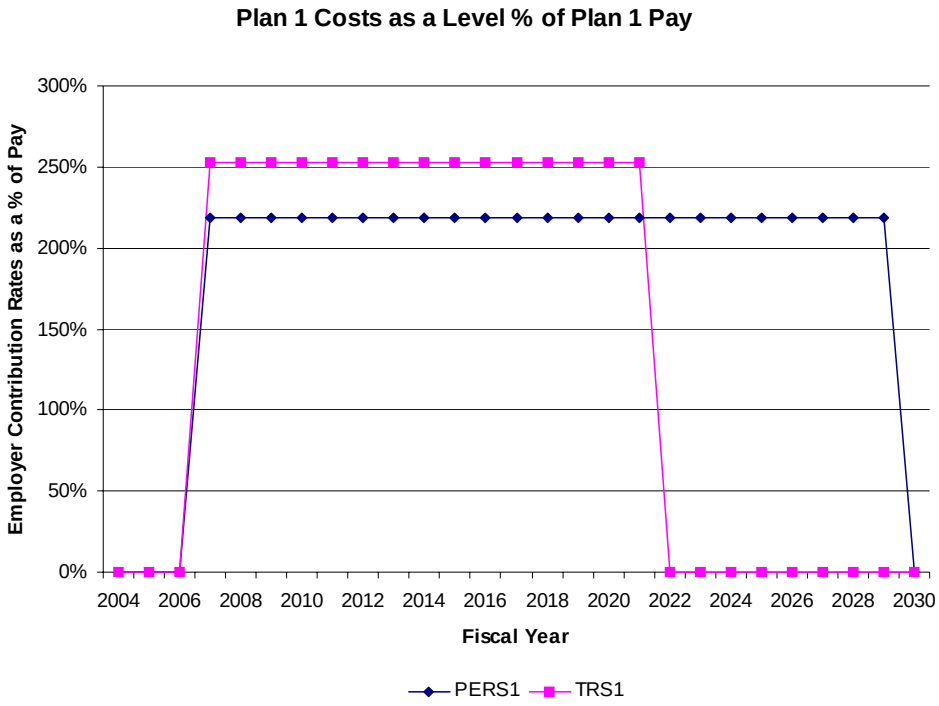
Policy Analysis

Intergenerational Equity

The statutory policy for intergenerational equity is codified within the actuarial funding chapter of the Revised Code of Washington. RCW 41.45.010(4) establishes the goal of funding, to the extent feasible, benefit increases for plan 1 members over the working lives of those members. The reason for this policy is so that the benefits are paid by the taxpayers who receive the benefits of those members' services.

The current funding methodology is inconsistent with this policy. The Plans 1 were closed in 1977. Now there are roughly three retirees for every active member in the Plans 1. The average age for active Plan 1 members is 55, the average number of years of service for PERS 1 is 21.4, and the average number of years service for TRS 1 is 23.9. There will be virtually no active members in the Plans 1 when the UAAL is paid off, assuming the legislature stays on track to fully pay the UAAL by June 30, 2024.

The following graph illustrates the magnitude of Plan 1 employer contribution rates that would be necessary if all remaining Plan 1 costs were spread over the working lifetimes of the remaining Plan 1 members. When the plans are funded over Plan 1 payroll, the PERS employer contribution rate jumps from about 3 percent to over 200 percent and the TRS rate increases from about 5.5 percent to over 250 percent.



Socializing the Cost

The Plan 1 UAAL is paid by employers (not members) as specified in Chapter 41.45 RCW. The Plan 1 UAAL costs have been considered too excessive to be absorbed by Plan 1 employers alone, as they would result in contribution rate increases that would be impossible for the Plan 1 employers to absorb. For this reason, the Plan 1 costs have been "socialized," or spread among all PERS,

TRS, SERS, and (starting July 1, 2006) PSERS employers. Thus all employers pay a total contribution rate equal to the plan 2/3 normal cost plus the Plan 1 UAAL rate.

The consequence of socializing the costs of the Plan 1 UAAL is that all employers pay the same contribution rates, even though the normal cost of the Plans 2/3 is less than the normal cost in the Plans 1. Contribution rates are uniform for employers regardless of the plan membership of their employees. Shifting the UAAL costs to other plans is not a common actuarial funding method, but this strategy has reduced Plan 1 contribution rates to something employers could manage.

The advantage of this approach is that a workable plan was created to accommodate the payoff schedule for the Plan 1 UAAL. The disadvantage is that Plan 2/3 employers are paying the costs for benefits to members that never render services to them. Socializing the Plan 1 UAAL costs creates an issue of parity between the plans. It also contributes to obscuring the true cost of the Plans 1 and any proposed benefit improvements for its members.

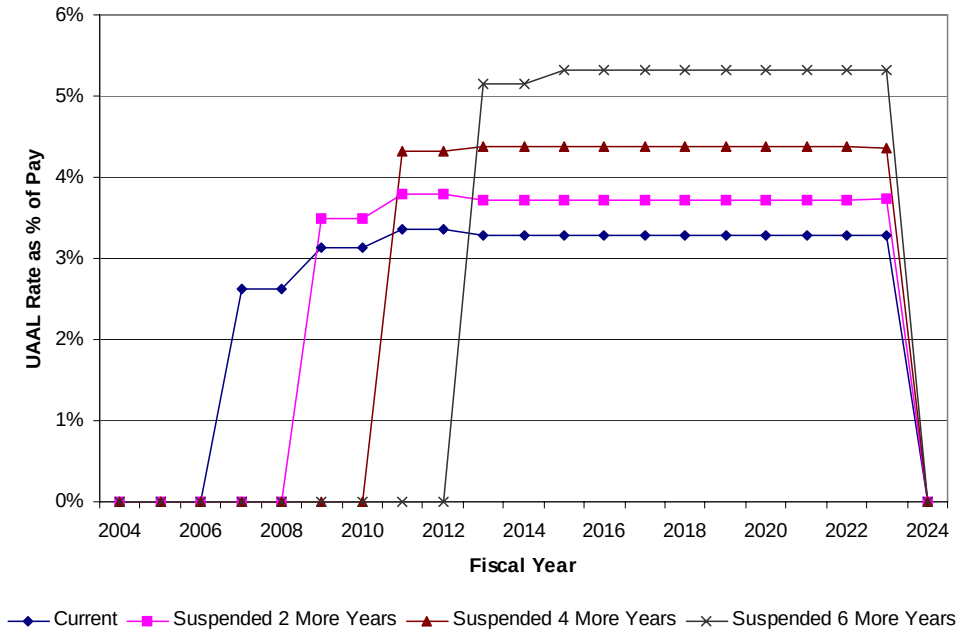
Full Amortization by June 30, 2024

The statutory funding policy for paying off the UAAL in the Plans 1 is also codified as a goal within the actuarial funding chapter. As shown above, adopting UAAL rates that would support intergenerational equity may not be realistic. This helps to explain why RCW 41.45.010(2) states that the funding process for the state retirement systems is intended to fully amortize the total Plan 1 costs by not later than June 30, 2024. This goal was a compromise that was set up to help close a funding gap that had been long-standing. The cost was made more manageable by spreading it out over time.

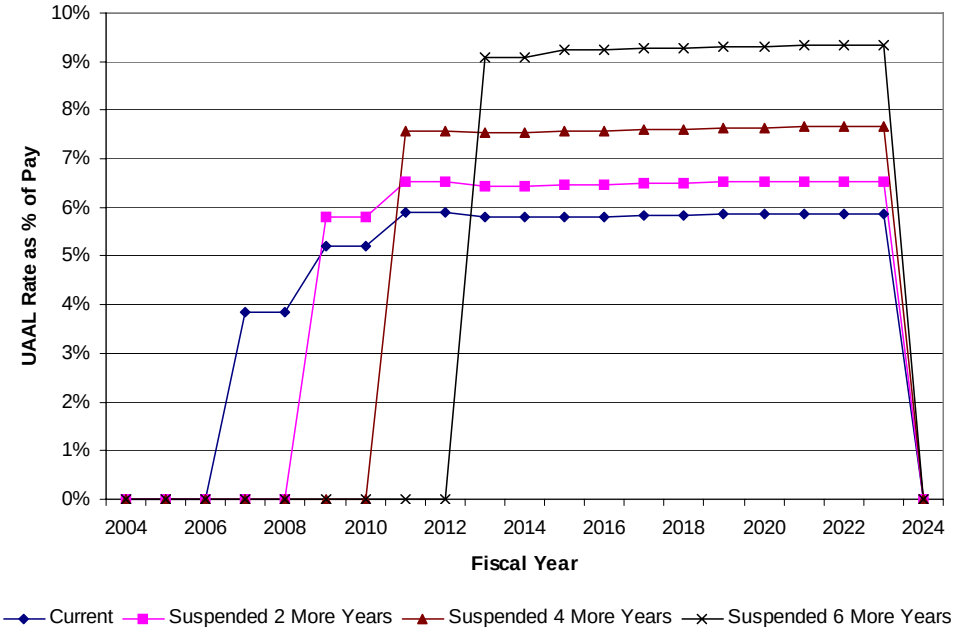
Spreading the Plan 1 UAAL costs out over time makes it appear that Plan 1 benefit increases have less effect on employer contribution rates when in fact, if the legislature used the same funding methodology that it applies to the Plans 2/3, the costs of benefit improvements would alter contribution rates much more quickly and therefore, more significantly.

It should be noted that payment of the Plan 1 UAAL has already been "back loaded," meaning that UAAL payments must increase over time to reach the deadline of June 30, 2024. The following are the projected contribution rates necessary to fully amortize the total Plan 1 costs by not later than June 30, 2024, *excluding gain-sharing*, and skipping one or more payments as noted:

PERS 1 Required Payment for UAAL Without Gain Sharing

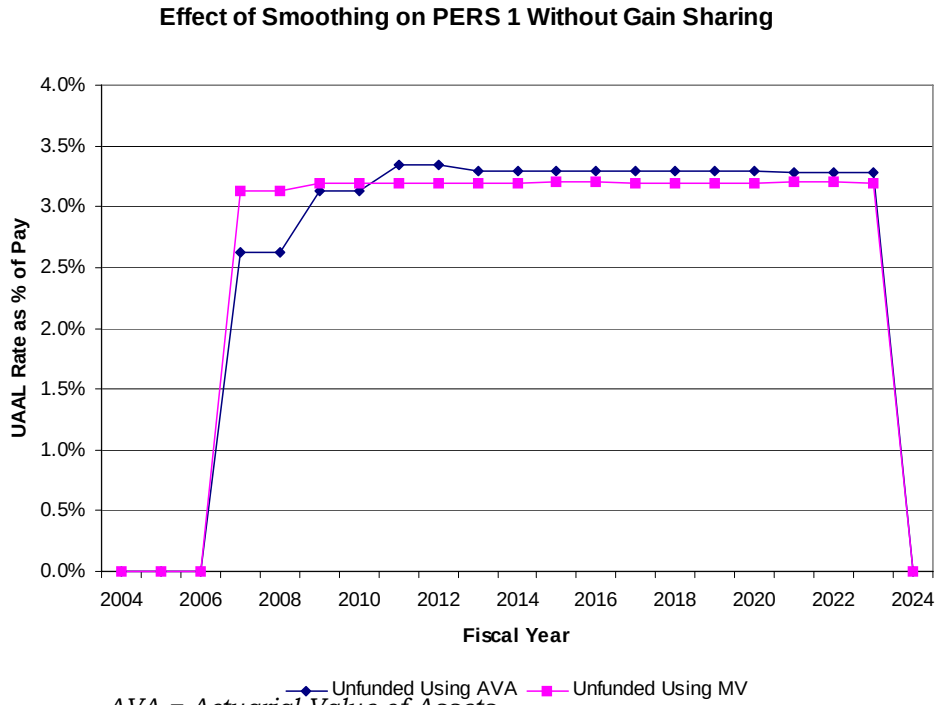


TRS 1 Required Payment for UAAL Without Gain Sharing

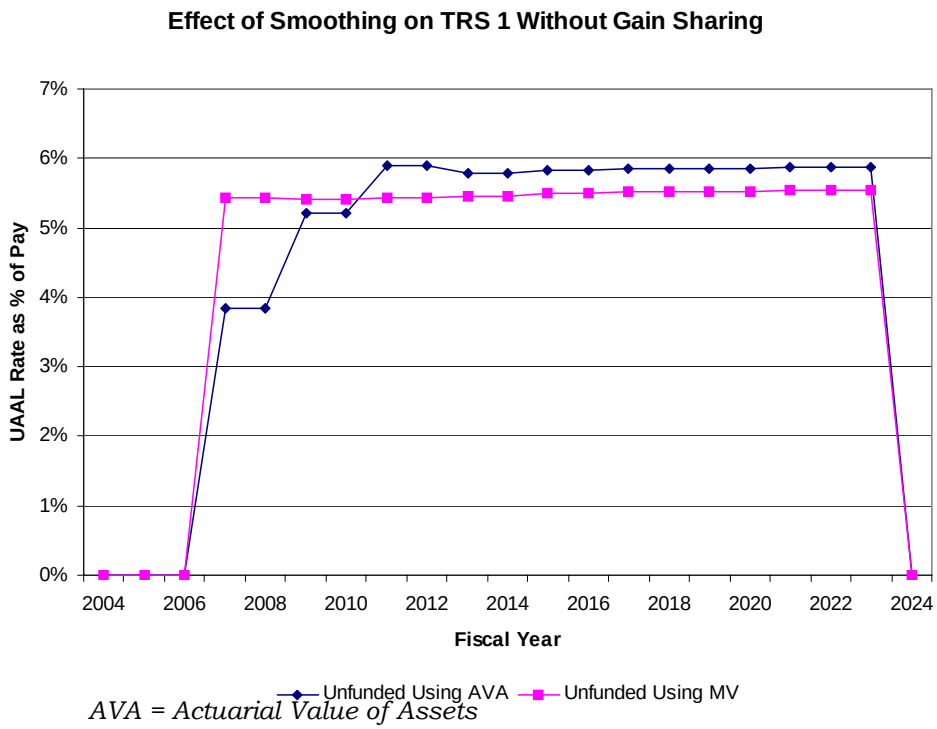


Effects of Smoothing

Asset smoothing is a method for deferring large increases or decreases in asset returns so as to avoid volatility in contribution rates. In Washington, we use a smoothing period of up to eight years with a market value corridor of 30 percent. In the short term, smoothing may contribute to a dynamic that temporarily obscures the unfunded costs of the Plans 1. This in turn may affect the willingness to improve Plan 1 benefits, as it may alter the short-term perceptions of the magnitude of the Plan 1 UAAL. As the graphs illustrate, assuming a static 8 percent annual investment return for all future years, the smoothing technique makes the step-up in required UAAL contribution rates more gradual for the first several years.



AVA = Actuarial Value of Assets
MV = Market Value of Assets



AVA = Actuarial Value of Assets
MV = Market Value of Assets

Economic Trends/Assumptions

The time frame that remains to address the Plan 1 UAAL payoff is now less than 20 years. The graphs above illustrate how payments are "back-loaded," meaning that the required contribution rates are significantly more in the future than what employers are currently used to paying. This fact becomes important to the UAAL payoff commitment, as required contribution rates become more sensitive to assumption changes and experience gains and losses in the final years of payoff.

It is useful to consider the effects of possible changes in economic trends and assumptions between now and the payoff date to understand how required UAAL contribution rates could be affected. For example if the assumed investment rate of return of 8 percent were not achieved over the next 19 years, and instead the fund returned 7.75 percent for the period, PERS required contribution rates would increase by .19 percent and TRS rates would increase by .33 percent for the period (without gain-sharing). Another way of

considering the role of investment returns is to look at the returns that would be required to avoid increasing UAAL rates between now and the payoff date. The required investment returns to achieve that goal (for the UAAL only) would be about 12 percent per year throughout the current amortization period.

Another key assumption in the projected UAAL payoff schedule is the assumption that future membership will grow at 1.25 percent per year (0.9 percent in TRS). A no-membership growth assumption would require an increase in required contribution rates of .31 percent for PERS and .33 percent for TRS (again, without gain-sharing). These scenarios illustrate how short-term changes in long-term assumptions can affect contribution rates.

Long-term vs. Short-term Approaches

In setting its goals for actuarial funding of the state retirement systems, the legislature stated its intent in RCW 41.45.010 to provide a dependable and systematic process for funding the benefits provided to members and retirees. Recent contribution holidays and suspension of payments for the Plan 1 UAAL have, however, prevented the build-up of any temporary "asset reserve" that could have accumulated to offset the investment losses of several years ago that are still being recognized under the current asset smoothing method.

Compounding the problem has been the use of annual actuarial valuation results to justify both reductions in contribution rates and suspension of liability payments. An actuarial valuation report is merely a "snapshot" in time. The snapshot approach can work well for budget writers, who tend to focus on the needs of the upcoming biennium. The short-term focus, however, ignores the long-term consequences of such actions to pension system funding and tends to threaten contribution rate adequacy over the long-term. Inadequate contribution rates can in turn undermine contribution rate stability, bond ratings and ultimately, benefit security for plan members.

Benefit security is particularly important in closed plans. With few actives to support new contributions to the system, and with more and more benefits being paid to retirees, adequate and secure funds must be available to pay promised benefits. This is especially important in states like Washington, which recognize vested pension benefits as contractual obligations of the state.

Public defined benefit plans are designed to be funded over the long-term. In fact, it is the long-term approach that makes these plans cost-effective for taxpayers. A long-term funding approach allows for the pooling and spreading of risks, resulting in greater economic efficiencies and economies of scale for taxpayers. Short-term interruptions in required funding create costs that must be picked up in the future. This can be referred to as borrowing from the future to pay for the present, or "pay less now - pay more later." Short-term under-funding undermines not only the "economic engine" of public pension funds, but also violates the legislative funding goal of intergenerational equity, a doctrine that is grounded in concepts of fairness to successive generations of taxpayers.

Relationship to Other Plan 1 Goals

Given the current legislative inability to fully fund the retirement systems, one could say that there is "not enough money to go around." That being the case, retiring the Plan 1 UAAL is at odds with proposals that increase Plan 1 benefit costs. When there is not enough money to go around, policy makers are forced to prioritize their goals and decide which is more important.

There is at least one major Plan 1 goal that is at odds with the goal of paying of the Plan 1 UAAL by 2024. Increasing Plan 1 retiree purchasing power has been a theme before the SCPP and before that, the JCPP, for many years. Related to this goal is the role of gain-sharing as a mechanism for increasing Plan 1 adjustments to retirement benefits.

Examples of Approaches Used to Address Pension Funding Concerns

Increasing Contributions

Starting July 1, 2005, employer and member contributions for New Mexico's Educational Retirement System will increase according to a four-year phase-in plan. Employer contributions will increase to 13.9 percent from 8.65 percent prior to the phase-in. Member contributions will increase from 7.65 percent to 7.9 percent over the four-year period.[1]

In Montana, bills providing actuarially necessary employer contribution increases for four retirement plans, phased in over four to six years, were tabled. Solutions may be proposed in a special legislative session at the end of the calendar year. [2]

Benefit Reductions and New Tiers

Oregon's 2003 reform legislation was introduced to save the retirement system money by altering the benefit structure. The resulting plan amendments were challenged in the courts. Provisions affecting new employees in the new tiers were upheld, but plan amendments affecting benefits for existing employees and retirees were struck down as a violation of vested contractual rights. As of April 2005, Oregon's actuaries estimated that the cost of the Oregon Supreme Court's final decision in the case would cost 2.7 percent of pay. The projected total employer contribution rate for July 1, 2007, is expected to be about 24 percent of pay (assuming the use of about $1.8 billion in reserves for pension fund purposes).[3]

The DB/DC Debate

The California governor's plan to place a defined contribution plan for public employees on the ballot was delayed, largely in response to pressure from public safety officers that the new plan did not offer disability or death benefits. The proposed employer defined contribution rates were lower than the current normal cost contributions employers pay for the defined benefit plan. Savings were projected to be up to $1 billion in annual retirement costs after the plan is fully phased in for all public employees. Such a phase-in could take several decades.[4]

West Virginia closed the Teachers' DC Retirement System to newly hired personnel and returned to a defined benefit plan because it is cheaper to run in the long-term. Existing members of the DC plan will elect whether to continue operating the DC plan or whether it should be merged with the DB plan. The bill also mandates an education program for members of the DC plan.[5]

Alaska's 2005 Retirement Security Act places new hires in a DC plan.[6]

Pension Obligation Bonds

In 1997, New Jersey borrowed $2.7 billion in pension obligation bonds to fill a gap in its public pension plan funding. These bonds, sometimes called POBs, are general obligation debt much like any government borrowing, but they are issued in order to put the proceeds into the pension funds instead of into the general government coffers. The bond issuer makes a bet that the borrowed money can be invested to earn more than the interest rate that the bonds must pay.

Because New Jersey's pension obligation bonds were issued only a few years before a big drop in the stock market, the Garden State's bond issue has become a cautionary tale of how wrong that bet can go. Since 1997, New Jersey's POBs have averaged an annual return well below the 7.6 percent they owe in interest. The borrowing, which was intended to boost the pension plans' assets, has instead become a painful multiplier of the state's existing pension problems. Currently facing a pension deficit of at least $25 billion, the state will have to contribute more than $1 billion to its pension fund next year, up from $100 million this year.[7]

In West Virginia voters recently rejected a plan to sell as much as $5.5 billion of bonds to help pay for unfunded pension liabilities. Under a state Supreme Court order, West Virginia has to close its pension funding gap by 2034.[8]

Pursuant to authority granted to it by legislation passed in 2004, California issued more than $2 billion in pension obligation bonds last year.[9]

According to www.bloomberg.com, the largest-ever pension obligation bond sale was by Illinois in June 2003, when the state sold $10 billion.[10]

Rate Stabilization

CalPERS is considering strategies to stabilize contribution rates. These strategies do not focus on rate adequacy but rather on keeping contribution rates at a relatively constant percentage of pay over time. CalPERS has been looking at a longer asset smoothing period (15 years), longer amortization periods for annual non-investment gains/losses (30 years rolling), minimum contributions for plans in surplus, and a "pension stabilization account" that could function as a "rainy day" account.[11]

Federal Policy Trends for "At risk" Plans

In the wake of the United Airlines pension plan default, H.R. 2830 (“the Pension Protection Act”) was recently introduced at the federal level to reform current pension funding rules and to reduce the number of under-funded private pension plans. The bill would also increase the premiums employers pay to the Pension Benefit Guarantee Corporation from $19 to $30 per plan participant.

The bill calls for more aggressive funding targets, shorter amortization periods for shortfalls, freezes on benefit improvements for at-risk plans, and increased disclosure to plan participants and beneficiaries. Plans with more retirees, older workers, more lump sum payments, and shrinking workforces would be required to make greater pension contributions than plans with fewer retirees, younger workers, less lump sum payments, and growing workforces. H.R. 2830 applies to both single and multi-employer plans in the private sector.[12]

Increased disclosure is also a private sector concern. In a report released on June 15, 2005, the SEC urged the Financial Accounting Standards Board (FASB) to reconsider its accounting guidance for private sector defined benefit plans and other post-retirement plans. The report maintains that current pension accounting rules that allow for a complex series of smoothing mechanisms make financial statements difficult to understand and less transparent.[13]

The national discussion on pension reform is moving toward tighter funding rules and increased disclosure. These reforms would avoid practices which "hide" pension costs, help provide benefit stability, and improve long-term management of pension funding.

Questions for Policymakers

- Can employers afford more increases in the required projected contribution rates for the Plan 1 UAAL?
- If Plan 1 liabilities are increased by Plan 1 benefit enhancements that are not supported by existing contribution rates, is it fair to ask future taxpayers and Plan 2/3 employers to pay for them?
- Are there ways to manage the Plan 1 UAAL and still provide ongoing reasonable benefit enhancements for Plan 1 members and retirees?
- How can benefit security be protected in the final years of the plan?
- Would employers prefer to avoid unexpected increases in contribution rates and the end of the UAAL amortization period?

Options for Managing the Plan 1 UAAL

Option 1: *Stop suspending UAAL payments.*

A policy to avoid suspending future Plan 1 UAAL payments could be codified into the actuarial funding chapter along with other funding policies.

Option 2: *If revenue forecasts improve, resume payments as early as the next year of this biennium.*

This option could lead to a "split rate" in PERS for state vs. local governments, since state and local revenues come from different sources. A split rate would affect accounting and administration details.

Option 3: *Change the funding policy to price Plan 1 benefit improvements more accurately.*

For actives, this option would spread the cost over remaining payroll and for retirees, over their remaining lifetimes. This approach would be more consistent with existing policy for intergenerational equity.

Option 4: *Phase in a step-up of UAAL rates, then level rates out so as to retire the UAAL earlier than (or no later than) June 30, 2024.*

After a phased step-up in UAAL rates, a level funding requirement could be established to pay of the Plan 1 UAAL in a timely manner.

Option 5: *Establish a minium contribution rate floor with a target funding ratio.*

A minimum employer contribution could be established as part of the basic employer contribution that would be allocated for the sole purpose of amortizing the Plan 1 UAAL. This minimum contribution would remain effective until the actuarial value of assets equals a target percentage (e.g. 125 percent) of the actuarial accrued liability for each plan or the amortization date, whichever comes first.

Executive Committee/SCPP Recommendations

The Executive Committee of the SCPP recommended at its June meeting that this issue be heard by the full committee in July. After its July briefing, the SCPP further considered Plan 1 Unfunded Liability Options in August. On August 23, 2005 the SCPP formed a technical subgroup to further explore the options. After several meetings, the subgroup recommended a three-year phase-in of Plan 1 UAAL contribution rates beginning July 1, 2006. It also recommended that Plan 1 UAAL minimum contribution rates with a target funding ratio be established as of July 1, 2009. The phase-in and rate floor are found in two separate bills that are proposed for the 2006 legislative session.

Conclusion

The Plan 1 UAAL continues to be a significant pension liability for the Washington State Retirement System employers. This report is presented as a reminder of the role this liability plays in pension funding and pension funding policy. Also, to the extent that future pension dollars must continue to be used to pay off this liability, there are significant implications for the viability of pending and future proposals to improve Plan 1 benefits. As the payoff date approaches, the consequences of avoiding or postponing this liability are magnified, and the effects on benefit security will become more pronounced.

Endnotes

1. http://www.era.state.nm.us/Legislative_News/Legislation_2005/legislation_2005.htm

2. http://data.opi.state.mt.us/bills/2005/billhtml/HB0148.htm and http://data.opi.state.mt.us/bills/2005/billhtml/HB0181.htm

3. http://oregon.gov/PERS/

4. http://www.igs.berkeley.edu/library/htPensionReform.html#Topic6

5. http://news-register.net/news/story/0621202005_new02.asp

6. http://www.akrepublicans.org/stedman/24/news/sted2005041101p.php

7. http://businessweek.com/magazine/content/05_24/b3937088.htm

8. http://www.bloomberg.com/apps/news?pid=71000001&refer=us&sid=aQtQETWakQHY

9. http://www.metnews.com/articles/jarv121203.htm

10. http://www.taxpayfedil.org/oct03.htm

11. http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2005/april/stabilization-policy.xml

12. http://thomas.loc.gov/cgi-bin/query/z?c109:H.R.2830:

13. http://www.sec.gov/news/press/2005-91.htm

Rate Floor with Target Funding Ratio

(October 17, 2005)

Example

The following are excerpts from HB 1324 (2005 session) and provide an example of a rate floor with a target funding ratio that was included in last year's SCPP proposal:

> *"Beginning July 1, 2009, an additional minimum 2.75 percent is added to the minimum employer contribution rate of 4.00 percent for the public employees' retirement system until the actuarial value of assets equals one hundred 125 percent of the actuarial accrued liability for the public employees' retirement system plan 1 or June 30, 2024, whichever comes first."*
>
> *"Upon completion of each biennial actuarial valuation, the pension funding council and the state actuary shall review the appropriateness of the minimum contribution rates and the pension funding council shall recommend to the legislature any adjustments as may be needed due to material changes in benefits or actuarial assumptions, methods, or experience."*

Purpose of a Rate Floor with a Target Funding Ratio

Rate Floor

The addition of a rate floor under current Plan 1 funding policy would:

- eliminate a potential form of rate escalation at the end of the scheduled amortization period;
- stabilize future rates; and
- improve the adequacy of Plan 1 unfunded actuarial accrued liability (UAAL) rates over the long-term.

Under current funding policy, employer contribution rates necessary to amortize the Plan 1 UAAL by June 30, 2024 fluctuate based on the results of a biennial actuarial valuation. There is currently no statutory floor rate in place and contributions to the PERS 1 and TRS 1 UAAL have been suspended since the beginning of the 2003-05 biennium.

Under current funding policy, Plan 1 UAAL rates decrease as Plan 1 funded status improves and increase as funded status weakens. Short-term fluctuations in Plan 1 UAAL rates are largely based on short-term investment performance and directly correlated with the plan's asset allocation policy. Riskier assets classes, with the reward of higher long-term investment return and lower long-term plan costs, will produce more volatile investment returns in the short-term. Asset smoothing techniques help dampen rate volatility, but on their own cannot eliminate rate volatility entirely during periods of extraordinary investment performance.

In the absence of a rate floor, Plan 1 UAAL rates will decrease below expected long-term levels during periods of extraordinary investment performance and then return to expected long-term levels after the downward cyclical investment markets that historically follow. Given the fixed statutory amortization date of June 30, 2024, any premature reduction of Plan 1 UAAL contribution rates in the short-term will lead to escalating Plan 1 UAAL contribution rates at the end of the amortization period.

A Plan 1 UAAL rate floor will eliminate this type of potential escalation in rates, stabilize future rates and improve the adequacy of Plan 1 UAAL rates over the long-term.

Funding Target

The addition of a funding target under current Plan 1 funding policy would serve two purposes:

- increase the likelihood that once amortized, future contributions to the Plan 1 UAAL would not be required; and
- ensure that the floor contribution rates do not produce an excessive asset reserve.

A target funding ratio would be attained when the plan's assets divided by the plan's actuarial accrued liability exceeds a target percentage - say 140 percent. The assets would be calculated under the current asset smoothing method and the liabilities would be calculated under current assumptions and methods for determining on-going contribution requirements.

A plan that is exactly 100 percent funded on a particular valuation date may require additional contributions in the future. The key is understanding the purpose of the measurement and the assumptions used to determine the funded status under that measurement.

The following is an excerpt for the 2003 actuarial certification letter:

> *"The primary purpose of this valuation is to determine contribution requirements for the systems listed above as of the valuation date and should not be used for other purposes."*

The purpose of this statement is to inform the reader that the valuation results will vary depending on the intended purpose of the measurement. Is the reader seeking contribution requirements for an open and on-going plan? Seeking the lump-sum contribution required to settle the plan's unfunded liabilities under a closed plan? Perhaps the reader would like to know the contribution rate required to completely amortize the Plan 1 UAAL by 2024 and be reasonably assured that no future contributions would be required under current plan provisions?

Clearly, the results of a single actuarial valuation cannot accommodate all of the purposes listed above. Each measurement requires a unique set of actuarial assumptions and methods that produces materially different results.

Under current funding policy, the Plan 1 UAAL rate is calculated using assumptions that model expected long-term economic and demographic conditions over an extended measurement period - say 30 to 40 plus years into the future. However, the current amortization date is June 30, 2024 - less than 20 years from today. Applying an interest rate assumption over a period shorter than the intended measurement period (i.e., the duration of the amortization period is less than the duration of the measurement period for all plan liabilities) increases the likelihood that the interest assumption will not be achieved over the remaining amortization period. As a result, it is more likely than not that contributions to the Plan 1 UAAL will be required after June 30, 2024.

One way of addressing this situation is to tie the Plan 1 UAAL amortization policy to a target funding ratio. This would avoid a separate and distinct measurement of the Plan 1 UAAL. Under a target funding ratio, contributions to the Plan 1 UAAL would continue until a "target reserve" is established and the target reserve would decrease the likelihood that further contributions would be required following the amortization period.

Combining the target funding ratio with the rate floor provides a form of a "check and balance" between these two policies. A rate floor without a target funding ratio could produce an excessive asset reserve and unnecessarily increase plan costs. A funding target without a floor contribution rate would likely not be attained.

Appropriate Level of Floor Rates

The selection of an appropriate rate floor requires actuarial judgement and actuarial projections. Certainly, the selection of any rate floor will improve the rate stability issues mentioned previously. However, the improvements from such a funding policy change would diminish as the level of the rate floor decreases as a percentage of the long-term expected contribution rate. A floor contribution rate between 80 and 100 percent of the expected long-term rate would be appropriate for this purpose. This would correspond with rates between 2.68 and 3.35 percent for PERS 1 and rates between 4.71 and 5.89 percent in TRS 1. (Note: these rates exclude the cost of future gain-sharing benefits).

Appropriate Target Funding Ratio

The selection of an appropriate target funding ratio also involves actuarial judgement. A funding target closer to 100 percent could produce an insufficient reserve for the purposes stated above. On the other hand, a target ratio in excess of 150 percent may produce an excessive reserve and unnecessarily increase the long-term cost of the plan. An excessive reserve could also lead to increased demand for benefit enhancements - further increasing the long-term cost of the plan.

Federal law concerning minimum funding requirements for qualified retirement plans in the private sector provides some insight on this topic. Prior to the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, the full funding limit credit under Section 412 of the Internal Revenue Code (IRC) was based on 150 percent of the plan's current liability. This was increased to 170 percent (for plan years beginning in 2003) following the

passage of EGTRRA. The provisions of EGTRRA are set to expire for plan years beginning after December 31, 2010. Section 412 of the IRC does not apply to governmental plans, but does provide one point of reference in regards to full funding.

A funding target of 125 to 150 percent would be appropriate. The State Actuary recommends a funding target of 125 percent.

Summary

The addition of a Plan 1 UAAL rate floor tied to a target funding ratio would:

- eliminate a potential form of rate escalation at the end of the scheduled amortization period;
- stabilize future rates;
- improve the adequacy of Plan 1 UAAL rates over the long-term;
- increase the likelihood that once amortized, future contributions to the Plan 1 UAAL would not be required; and
- ensure that the floor contribution rates do not produce an excessive asset reserve.

The State Actuary recommends a floor contribution rate between 80 and 100 percent of the expected long-term rate. This would correspond with rates between 2.68 and 3.35 percent for PERS 1 and rates between 4.71 and 5.89 percent in TRS 1. (Note: these rates exclude the cost of future gain-sharing benefits).

The State Actuary recommends a funding target of 125 percent.

Next Steps

The subgroup will need to select floor PERS 1/TRS 1 UAAL rates (and decide whether or not to include the cost of future gain-sharing benefits) and select a target funding ratio. Staff will then prepare draft bill language for the full committee.

Select Committee on Pension Policy

Rate Phase-In Proposals

(November 7, 2005)

Phase-In Proposals

- **Current Law** - no rate phase-in; full Plan 1 UAAL rates resume at the beginning of the 2007-09 biennium
- **1-Year Phase-In with Catch-Up** - full 2005-07 payment with interest made during 2006-07; no phase-in thereafter
- **3-Year Phase-In with Catch-Up** - full 2005-2007 payment with interest made during 2006-2009; no phase-in thereafter
- **4-Year Phase-In with Catch-Up** - full 2005-2007 payment with interest made during 2006-2010; no phase-in thereafter
- **2-Year Phase-In** - rate increases over 2006-08 with the same present value as current law over a 2-year phase-in period
- **3-Year Phase-In** - rate increases over 2006-09 with the same present value as current law over a 3-year phase-in period
- **4-Year Phase-In** - rate increases over 2006-10 with the same present value as current law over a 4-year phase-in period

Plan 1 UAAL Rate Phase-In Schedules*

	2006-07	2007-08	2008-09	2009-10	2010-11
PERS 1					
Current Law	0.00%	2.63%	2.63%	3.13%	3.13%
1-Year Phase-in with Catch-up	3.44%	2.38%	2.38%	2.88%	2.88%
3-Year Phase-in with Catch-up	1.38%	2.76%	4.14%	2.88%	2.88%
4-Year Phase-in with Catch-up	1.12%	2.24%	3.36%	4.48%	2.88%
2-Year Phase-in	0.87%	1.75%	2.63%	3.13%	3.13%
3-Year Phase-in	0.87%	1.75%	2.63%	3.13%	3.13%
4-Year Phase-in	0.84%	1.68%	2.51%	3.35%	3.13%
TRS 1					
Current Law	0.00%	3.85%	3.85%	5.21%	5.21%
1-Year Phase-in with Catch-up	4.05%	3.55%	3.55%	4.91%	4.91%
3-Year Phase-in with Catch-up	1.88%	3.75%	5.63%	4.91%	4.91%
4-Year Phase-in with Catch-up	1.62%	3.24%	4.87%	6.49%	4.91%
2-Year Phase-in	1.28%	2.54%	3.85%	5.21%	5.21%
3-Year Phase-in	1.29%	2.55%	3.83%	5.21%	5.21%
4-Year Phase-in	1.29%	2.58%	3.86%	5.15%	5.21%

* All rates shown in this exhibit exclude the cost of future gain-sharing benefits. The UAAL rates are in addition to the normal cost rates for PERS, SERS, TRS, and PSERS.

Total Employer Rates under Phase-In Schedules*

	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011
PERS					
Current Law	3.50%	6.69%	7.37%	7.33%	7.33%
1-Year Phase-in with Catch-up	6.94%	6.44%	7.12%	7.08%	7.08%
3-Year Phase-in with Catch-up	4.88%	6.82%	8.88%	7.08%	7.08%
4-Year Phase-in with Catch-up	4.62%	6.30%	8.10%	8.68%	7.08%
2-Year Phase-in	4.37%	5.81%	7.37%	7.33%	7.33%
3-Year Phase-in	4.37%	5.81%	7.37%	7.33%	7.33%
4-Year Phase-in	4.34%	5.74%	7.25%	7.55%	7.33%
TRS					
Current Law	3.25%	7.14%	7.63%	9.86%	9.86%
1-Year Phase-in with Catch-up	7.30%	6.84%	7.33%	9.56%	9.56%
3-Year Phase-in with Catch-up	5.13%	7.04%	9.41%	9.56%	9.56%
4-Year Phase-in with Catch-up	4.87%	6.53%	8.65%	11.14%	9.56%
2-Year Phase-in	4.53%	5.83%	7.63%	9.86%	9.86%
3-Year Phase-in	4.54%	5.84%	7.61%	9.86%	9.86%
4-Year Phase-in	4.54%	5.87%	7.64%	9.80%	9.86%

*All rates shown in this exhibit exclude the cost of future gain-sharing benefits and an administrative expense rate of 0.19%.

Fiscal Impact of the Phase-In Schedules

Costs (in Millions):	1 Year Phase-in w/ Catch-up	3 Year Phase-in w/ Catch-up	4 Year Phase-in w/ Catch-up	2 Year Phase-in	3 Year Phase-in	4 Year Phase-in
2006-2007						
State:						
General Fund	$ 180.5	$ 79.2	$ 66.9	$ 52.5	$ 52.7	$ 52.0
Non-General Fund	$ 91.5	$ 36.7	$ 29.8	$ 23.1	$ 23.1	$ 22.3
Total State	**$ 272.0**	**$ 115.9**	**$ 96.7**	**$ 75.6**	**$ 75.8**	**$ 74.3**
Local Government	$ 216.2	$ 90.5	$ 74.8	$ 58.4	$ 58.6	$ 57.2
Total Employer	$ 488.2	$ 206.4	$ 171.5	$ 134.0	$ 134.4	$ 131.5
Total Employee	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
2007-2008						
State:						
General Fund	$ (14.6)	$ 0.1	$ (26.9)	$(58.6)	$(58.4)	$(59.1)
Non-General Fund	$ (7.0)	$ 3.7	$ (11.0)	$(24.8)	$(24.8)	$(26.7)
Total State	**$ (21.6)**	**$ 3.8**	**$ (37.9)**	**$(83.4)**	**$(83.2)**	**$(85.8)**
Local Government	$ (16.8)	$ 4.9	$ (28.1)	$(62.7)	$(62.6)	$(65.5)
Total Employer	$ (38.4)	$ 8.7	$ (66.0)	$(146.1)	$(145.8)	$(151.3)
Total Employee	$ 0.0	$ 0.0	$ 0.0	$0.0	$0.0	$0.0

Costs (in Millions):	1 Year Phase-in w/ Catch-up	3 Year Phase-in w/ Catch-up	4 Year Phase-in w/ Catch-up	2 Year Phase-in	3 Year Phase-in	4 Year Phase-in
2008-2009						
State:						
General Fund	$ (15.4)	$ 91.8	$ 49.3	$ 0.0	$ (0.6)	$ (2.7)
Non-General Fund	$ (7.4)	$ 45.0	$ 21.7	$ 0.0	$ 0.0	$ (3.6)
Total State	**$ (22.8)**	**$ 136.8**	**$ 71.0**	**$ 0.0**	**$ (0.6)**	**$ (6.3)**
Local Government	$ (17.7)	$ 106.4	$ 53.9	$ 0.0	$ (0.3)	$ (6.1)
Total Employer	$ (40.5)	$ 243.2	$ 124.9	$ 0.0	$ (0.9)	$ (12.4)
Total Employee	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
2009-2010						
State:						
General Fund	$ (16.3)	$ (16.3)	$ 76.7	$ 0.0	$ 0.0	$ 3.9
Non-General Fund	$ (7.9)	$ (7.9)	$ 42.5	$ 0.0	$ 0.0	$ 6.9
Total State	**$ (24.2)**	**$ (24.2)**	**$ 119.2**	**$ 0.0**	**$ 0.0**	**$ 10.8**
Local Government	$ (18.7)	$ (18.7)	$ 95.6	$ 0.0	$ 0.0	$ 11.2
Total Employer	$ (42.9)	$ (42.9)	$ 214.8	$ 0.0	$ 0.0	$ 22.0
Total Employee	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
2010-2011						
State:						
General Fund	$ (17.2)	$ (17.2)	$ (17.2)	$ 0.0	$ 0.0	$ 0.0
Non-General Fund	$ (8.3)	$ (8.3)	$ (8.3)	$ 0.0	$ 0.0	$ 0.0
Total State	**$ (25.5)**	**$ (25.5)**	**$ (25.5)**	**$ 0.0**	**$ 0.0**	**$ 0.0**
Local Government	$ (19.8)	$ (19.8)	$ (19.8)	$ 0.0	$ 0.0	$ 0.0
Total Employer	$ (45.3)	$ (45.3)	$ (45.3)	$ 0.0	$ 0.0	$ 0.0
Total Employee	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
2006-2031 (25 Year)						
State:						
General Fund	$ (215.8)	$ (195.2)	$ (184.0)	n/a	n/a	n/a
Non-General Fund	$ (103.6)	$ (95.3)	$ (89.8)	n/a	n/a	n/a
Total State	**$ (319.4)**	**$ (290.5)**	**$ (273.8)**	n/a	n/a	n/a
Local Government	$ (244.7)	$ (224.6)	$ (211.5)	n/a	n/a	n/a
Total Employer	$ (564.1)	$ (515.1)	$ (485.3)	n/a	n/a	n/a
Total Employee	$ 0.0	$ 0.0	$ 0.0	n/a	n/a	n/a

BILL REQUEST - CODE REVISER'S OFFICE

BILL REQ. #: Z-0884.3/06 3rd draft

ATTY/TYPIST: LL:rmh

BRIEF DESCRIPTION: Funding the unfunded actuarial accrued liability in plan 1 of the public employees' retirement system and plan 1 of the teachers' retirement system.

AN ACT Relating to payment of the unfunded actuarial accrued liability in plan 1 of the public employees' retirement system and plan 1 of the teachers' retirement system; adding a new section to chapter 41.45 RCW; and providing an effective date.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

NEW SECTION. **Sec. 1.** A new section is added to chapter 41.45 RCW to read as follows:

(1) It is the intent of the legislature to provide for the systematic payment of the plan 1 unfunded actuarial accrued liability in a manner that promotes contribution rate adequacy and stability for the affected systems. This change in funding policy requires a three-year phase-in of contribution rates beginning in 2006. The phase-in rates for the plan 1 unfunded actuarial accrued liability are in addition to the phase-in rates established pursuant to RCW 41.45.062.

(2) Beginning July 1, 2006, a 0.87 percent contribution is established as part of the basic state and employer contribution rate for the public employees' retirement system and the public safety employees' retirement system, to be used for the sole purpose of

amortizing the unfunded actuarial accrued liability in the public employees' retirement system plan 1.

(3) Beginning September 1, 2006, a 0.87 percent contribution is established as part of the basic state and employer contribution rate for the school employees' retirement system, to be used for the sole purpose of amortizing the unfunded actuarial accrued liability in the public employees' retirement system plan 1.

(4) Beginning September 1, 2006, a 1.29 percent contribution is established as part of the basic state and employer contribution rate for the teachers' retirement system, to be used for the sole purpose of amortizing the unfunded actuarial accrued liability in the teachers' retirement system plan 1.

(5) Upon completion of the 2005 actuarial valuation, the pension funding council and the state actuary shall review the contribution rates for the plan 1 unfunded actuarial accrued liability for 2007-2008 and 2008-2009 and by September 30, 2006, the pension funding council shall adopt contribution rates to complete the three-year phase-in schedule, adjusted for any material changes in benefits or actuarial assumptions, methods, and experience. The expected present value of projected contributions during the three-year phase-in period shall be the same as the expected present value of projected contributions that would have been collected without the phase-in, as determined by the state actuary and adjusted for any material changes in benefits or actuarial assumptions, methods, or experience.

NEW SECTION. **Sec. 2.** This act takes effect July 1, 2006.

--- END ---

DRAFT FISCAL NOTE

REQUEST NO.

RESPONDING AGENCY:	CODE:	DATE:	BILL NUMBER:
Office of the State Actuary	035	12/20/05	Z-0884.3 / Z-1019.2

SUMMARY OF BILL:

This bill impacts the Plans 1 of the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS). The proposed legislation would establish a three-year phase-in of contribution rates to be used for the sole purpose of paying the unfunded actuarial accrued liability (UAAL) in those plans. The phase-in rates are in addition to the phase-in rates established pursuant to RCW 41.45.062.

In the 2006-2007 fiscal year, the rates would be 0.87% for the PERS 1 UAAL and 1.29% for the TRS 1 UAAL. The contribution rates for years two and three of the phase-in would be adopted by the pension funding council according to the following standard: the expected present value of projected contributions during the three-year phase-in period would be the same as the expected present value of projected contributions that would have been collected without the phase-in, as determined by the state actuary and adjusted for any material changes in benefits or actuarial assumptions, methods or experience.

Effective Date: July 1, 2006

CURRENT SITUATION:

Payments to amortize the Plan 1 UAAL are normally collected as a component of employer contribution rates. According to current funding policy, liability for the Plans 1 is spread among all PERS, TRS, SERS and PSERS employers. This liability is also spread over time. Current funding policy requires that the UAAL be fully amortized by June 30, 2024.

Payments for the Plan 1 UAAL have been suspended for the current biennium, and were suspended in the previous biennium. Regular payments are scheduled to resume July 1, 2007.

MEMBERS IMPACTED:

The bill would impact all 75,390 members of PERS 1 and all 45,961 members of TRS 1 by recommencing employer contributions in 2006 instead of 2007.

PERS Plan 1	Members
Receiving a Benefit	54,568
Actives	17,829
Terminated & Vested	2,993

TRS Plan 1	Members
Receiving a Benefit	34,624
Actives	9,862
Terminated & Vested	1,475

Member contributions would not change as a result of this bill.

ASSUMPTIONS:

The bill establishes a schedule of smoothed or phased-in contribution rates for 2006-2009. The rates for 2006-07 are specified. We assume that the 2007-2009 Plan 1 UAAL rates will be adjusted so that the expected present value of the contributions over 2006-2009 would be the same with or without the phase-in.

FISCAL IMPACT:

The rates under the 3-year phase-in will be higher in the 2006-07 than required under current law, and will be lower in 2007-08 and 2008-09 than required under the projected 2005 actuarial valuation.

Actuarial Determinations:

The bill will impact the actuarial funding of the system by increasing the present value of benefits payable under the System and the required actuarial contribution rate as shown below:

(Dollars in Millions)		Current	Increase	Total
Actuarial Present Value of Projected Benefits	PERS	$28,098	$0	$28,098
(The Value of the Total Commitment to all Current Members)	TRS	$15,616	$0	$15,616
	SERS	$2,126	$0	$ 2,126
Unfunded Actuarial Accrued Liability	PERS 1	$2,563	$0	$2,563
(The Portion of the Plan 1 Liability that is Amortized at 2024)	TRS 1	$1,415	$0	$1,415
Unfunded Liability (PBO)	PERS	($673)	$0	($673)
(The Value of the Total Commitment to all Current Members Attributable to Past Service)	TRS	($235)	$0	($235)
	SERS	($439)	$0	($439)

Increase in Contribution Rates:

We determined that the following adjustments to the Plan 1 UAAL rates would result in the same present value of contributions. The rates are effective 7/1/06 for PERS and PSERS, and 9/1/06 for TRS and SERS:

Year	PERS / SERS / PSERS	TRS
2006-2007	0.87%	1.29%
2007-2008	(0.88)%	(1.30%)
2008-2009	0.00%	(0.02%)
2009-2011 & thereafter	0.00%	0.00%

There is no change to the member rates.

Fiscal Budget Determinations:

As a result of the higher (lower) required contribution rate, the increase (decrease) in funding expenditures is projected to be:

Costs (in Millions):	PERS*	TRS	SERS	Total
2006-2007				
State:				
General Fund	$14.0	$34.2	$4.5	$52.7
Non-General Fund	$23.1	$0.0	$0.0	$23.1
Total State	$37.1	$34.2	$4.5	$75.8
Local Government	$33.0	$18.8	$6.8	$58.6
Total Employer	$70.1	$53.0	$11.3	$134.4
Total Employee	$0.0	$0.0	$0.0	$0.0
2007-2009				
State:				
General Fund	($15.0)	($38.4)	($5.6)	($59.0)
Non-General Fund	($24.8)	$0.0	$0.0	($24.8)
Total State	($39.8)	($38.4)	($5.6)	($83.8)
Local Government	($35.3)	($19.2)	($8.4)	($62.9)
Total Employer	($75.1)	($57.6)	($14.0)	($146.7)
Total Employee	$0.0	$0.0	$0.0	$0.0

Costs (in Millions):	PERS*	TRS	SERS	Total
2006-2031				
State:				
General Fund	($1.0)	($4.2)	($1.1)	($6.3)
Non-General Fund	($1.7)	$0.0	$0.0	($1.7)
Total State	($2.7)	($4.2)	($1.1)	($8.0)
Local Government	($2.3)	($0.4)	($1.6)	($4.3)
Total Employer	($5.0)	($4.6)	($2.7)	($12.3)
Total Employee	$0.0	$0.0	$0.0	$0.0

* Includes PSERS effective 7/1/06

State Actuary's Comments:

This fiscal note involves calculations that require assumptions about future economic events and acts of future Legislatures. It assumes that the cost of future gain sharing will not be recognized under the phase-in schedule, that the contribution rates for 2007-2009 will be adjusted to complete the 3-year phase-in schedule, and that the Plan 1 amortization payments will resume in 2006 with no change in the amortization date. If any of these events occur differently than assumed, then the long term cost of this bill will change.

STATEMENT OF DATA AND ASSUMPTIONS USED IN PREPARING THIS FISCAL NOTE:

The costs presented in this fiscal note are based on our understanding of the bill as well as generally accepted actuarial standards of practice including the following:

1. Costs were developed using the same membership data, methods, assets and assumptions as those used in preparing the September 30, 2004 actuarial valuation report of the Public Employees' Retirement System Retirement System, the Teachers' Retirement System, and the School Employees' Retirement System.

2. As with the costs developed in the actuarial valuation, the emerging costs of the System will vary from those presented in the valuation report or this fiscal note to the extent that actual experience differs from that projected by the actuarial assumptions.

3. Additional assumptions used to evaluate the cost impact of the bill which were not used or disclosed in the actuarial valuation report, or within the body of this fiscal note, include the following: None

4. The analysis of this bill does not consider any other proposed changes to the system. The combined effect of several changes to the system could exceed the sum of each proposed change considered individually.

5. This draft fiscal note is intended for use only during the 2006 Legislative Session.

6. The funding method used for Plan 1 utilizes the Plan 2/3 employer/state rate as the Normal Cost and amortizes the remaining liability (UAAL) by the year 2024. Benefit increases to Plan 2/3 will change the UAAL in Plan 1. The cost of benefit increases to Plan 1 increases the UAAL.

7. Plan 2/3 utilizes the Aggregate Funding Method. The cost of Plan 2/3 is spread over the average working lifetime of the current active Plan 2/3 members.

8. Entry age normal cost rate increases are used to determine the increase in funding expenditures for future new entrants. Aggregate rate increases are used to calculate the increase in funding expenditures for current plan members.

GLOSSARY OF ACTUARIAL TERMS:

Actuarial accrued liability: Computed differently under different funding methods, the actuarial accrued liability generally represents the portion of the present value of fully projected benefits attributable to service credit that has been earned (or accrued) as of the valuation date.

Actuarial Present Value: The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of Actuarial Assumptions (i.e. interest rate, rate of salary increases, mortality, etc.)

Aggregate Funding Method: The Aggregate Funding Method is a standard actuarial funding method. The annual cost of benefits under the Aggregate Method is equal to the normal cost. The method does not produce an unfunded liability. The normal cost is determined for the entire group rather than an individual basis.

Entry Age Normal Cost Method (EANC): The EANC method is a standard actuarial funding method. The annual cost of benefits under EANC is comprised of two components:

- Normal cost; plus
- Amortization of the unfunded liability

The normal cost is determined on an individual basis, from a member's age at plan entry, and is designed to be a level percentage of pay throughout a member's career.

Normal Cost: Computed differently under different funding methods, the normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year.

Pension Benefit Obligation (PBO): The portion of the Actuarial Present Value of future benefits attributable to service credit that has been earned to date (past service).

Projected Benefits: Pension benefit amounts which are expected to be paid in the future taking into account such items as the effect of advancement in age as well as past and anticipated future compensation and service credits.

Unfunded Liability (Unfunded PBO): The excess, if any, of the Pension Benefit Obligation over the Valuation Assets. This is the portion of all benefits earned to date that are not covered by plan assets.

Unfunded Actuarial Accrued Liability (UAAL): The excess, if any, of the actuarial accrued liability over the actuarial value of assets. In other words, the present value of benefits earned to date that are not covered by plan assets.

Washington State
School Retirees Association

4726 Pacific Ave. SE Lacey, WA 98503-1216 • PHONE (360) 413-5496

MEMORANDUM

TO: Select Committee on Pension Policy (SCPP) Plan 1 Unfunded Liability Subgroup
Victor Moore, Chair
Senator Craig Pridemore
Representative Barbara Bailey
Glenn Olson – PERS Employer Representative

FROM: Robert Rhule, WSSRA Legislative Committee Chair
Leslie Main, WSSRA Legislative Coordinator

DATE: October 20, 2005

RE: Calculation of Unfunded Liability Costs

The Washington State School Retirees' Association (WSSRA) has a long and consistent record of advocating responsible pension funding, particularly with respect to amortization of the TRS/PERS Plan 1 Unfunded Liability. Accordingly, we are very appreciative and interested in the SCPP's desire to put forth a recommendation to the Legislature as to the resumption of payment toward this important employer obligation. It was our original understanding that the Plan 1 Unfunded Liability Subgroup was charged with analysis of the technical aspects of options related to the Unfunded Liability; the results of which would then be communicated to the full SCPP for their use in developing a policy recommendation. We are now aware that the Subgroup has decided to put forth a policy recommendation to the full SCPP.

WSSRA understands that payment of the TRS/PERS 1 Unfunded Liability represents a challenge to General Fund-State (GF-S), non-GF-S, and local government employers alike. However, it is our concern that omission of future Gain Sharing costs from a policy recommendation of the Plan 1 Unfunded Liability Subgroup would not fully represent total material liabilities of the TRS/PERS 1 pension funds. A case could be made that enactment of ESHB 1044 by the Legislature during the 2005 Session justifies omission of Gain Sharing costs from calculation of Unfunded Liability contributions during the remainder of the 2005-07 biennium. Nonetheless, it is the strong belief of WSSRA that until the Legislature takes definitive action on Gain Sharing, the costs of future Gain Sharing disbursements resulting from currently established statute should be accounted for in any calculation of Unfunded Liability obligations from 2007-09 and beyond.

Aside from the fiscal ramifications, WSSRA is also concerned about the policy implications of omitting the costs of future Gain Sharing disbursements from any recommendation of the Plan 1 Unfunded Liability Subgroup. We understand that some parties may hope to see a repeal of Gain Sharing benefits without any replacement benefits and thus realize only savings to employers. However, such a total "take away" of Gain Sharing benefits by the Legislature is not a forgone conclusion that should be utilized in the development of a policy recommendation dealing with resumption of employer payments toward the Plan 1 Unfunded Liability.

WSSRA therefore requests that any policy recommendation put forth by the Plan 1 Unfunded Liability Subgroup to the full SCPP be accompanied by cost estimates which include the cost of future Gain Sharing benefits. Thank you for your consideration of these important issues.

cc: Representative Bill Fromhold, SCPP Chair
Senator Karen Fraser, SCPP Vice-Chair
Matt Smith, State Actuary