Building a 21st Century Government: Reforming Pensions

Summary Materials for Governor Gregoire's Policy Proposals
January 2011

Last summer, Governor Gregoire convened a group of experts to look at the state's pension systems. They were tasked to consider best practices and future state needs in identifying what changes should be made in public employee pensions and retiree health care to make those programs more sustainable. They were to consider:

1. Costs for both employees and public employers,
2. Maintaining benefit programs that attract and retain key skills,
3. Employee financial security in retirement and
4. Simplicity.

From this review, the Governor made the following proposals.

REFORMING PENSIONS TO HOLD DOWN COSTS

Washington has been a national leader in designing and maintaining sustainable public pension plans. Current open retirement plans have had reasonable benefit levels and are fully funded. The older, more generous retirement plans were closed to new members in 1977, when the current plans were created. As many states struggle to address staggering pension liabilities, they are doing what Washington did in 1977: raising the retirement age, requiring more cost-sharing between members and employers, and limiting opportunities to inflate pensions with late career salary increases. Money spent on state pensions means less funding available for essential services such as education and public safety.

We continue to innovate. We were the first state to use hybrid defined contribution/defined benefit plans. Our State Investment Board has followed progressive investment policies, which has led to an 8 percent return for the past 20 years — among the top 10 percent of public pension plans over this time period.

While Washington is in an enviable position in some respects, we recognize that significant challenges lie ahead. The older closed plans are underfunded, and will fall further behind. Unless action is taken, underfunding will cause employer pension contribution rates to double in the 2011–13 biennium and remain high for the next 20 years. This will make it difficult to maintain the healthy funded status of the open plans.

Just like Washington did 33 years ago, when we closed the older plans and moved to less-generous, more-modern benefit plans, we must again make hard decisions. Governor Gregoire proposes the following actions to reduce future costs to employers and taxpayers while maintaining reasonable benefits for valued public employees and retirees.

Eliminate automatic benefit increases
In 1995, the Legislature passed an annual benefit increase for members and beneficiaries in public pension plans closed to new members since 1977. While intended to protect against inflation, the increase itself was not linked to inflation, which has been low. The Legislature

anticipated the benefit could have a high cost, so it reserved the right to amend or repeal the benefit in the future.

The closed plans for teachers (TRS 1) and public employees (PERS 1) were identified by the State Actuary last year as the state's only unhealthy pension plans, with funded ratios between 70 and 75 percent, or an unfunded liability approaching $7 billion as of June 30, 2009. (The remaining plans had funding ratios that exceeded 116 percent.)

The Governor proposes to end future automatic benefit increases from the 1995 legislation, which would eliminate more than one-half of the unfunded liability in the closed plans. The Legislature, as was the case prior to 1995, could award cost-of-living increases at its discretion. The repeal will also reduce public employer payments by an estimated $9 billion over the next 25 years, with $2 billion of that reduction expected to be realized over the next two biennia. The Office of the State Actuary estimates that $4 billion of the $9 billion savings will be realized by local governments over this period. For the next two years, local governments will save $353 million and the state will save $368 million.

The Governor's proposal removes the annual increase amount only for members and beneficiaries whose monthly pensions exceed the minimum benefits provided in the plans. Retirees receiving the minimum benefit amounts will not be affected — their benefits will continue to be adjusted annually.

Modernize the public pensions

In 1977, state policymakers created new retirement benefits for public employees. While policymakers balanced the provision of benefits with affordability for employers and reasonableness for taxpayers, times and circumstances have changed. Since then, we have seen significant changes to retirement patterns and personal longevity, not to mention retirement options available to the public. At the same time, costs to provide public employees with no-risk pensions at ages far earlier than offered by Social Security are rising.

The Governor proposes to discontinue incentives to retire earlier than age 65 for new hires in Plans 2 and 3 for PERS, TRS and SERS. This modernization of the state's primary pension systems will slash the long-term cost of public pensions by an estimated $2.2 billion over 25 years for state and local governments, freeing scarce resources for other essential functions.

Reform higher education pensions

»**Close the retire-rehire exception**

In 2001, lawmakers expanded the opportunity for retirees from state-administered retirement systems to return to work while still receiving their monthly pension. This change allowed employers to use experienced retirees as a short-term solution to bridge a recruitment gap for long-term personnel, especially in the education field. In 2003, lawmakers added safeguards and limits on the number of hours retirees could work while still receiving their pension.

Still, an exception occurs when a retired public employee returns to work for an institution of higher education and participates in a separate retirement plan offered by the institution.

Participation in the other retirement plan exempts the retiree from limits in the state-administered retirement plan. In this situation, the retiree can work and draw full retirement and salary.

The Governor proposes to close this exception by disallowing retired employees from participating in these separate retirement plans. Restrictions will also be imposed to not allow individuals to draw full-time retirement benefits as well as a salary.

»**Align state contributions**

The Governor proposes to align state support for higher education retirement plans more closely with that provided for other state employees. These plans now provide both a defined contribution amount and a supplemental guaranteed minimum benefit similar to the formula used in the old state pension systems that closed in 1977. As an alternative, new higher education employees would be given the option to participate in one of the state's hybrid pension plans.

The Governor's proposal will cap the state's contribution to these plans at 6 percent. The higher education institutions could contribute more. For 2011–13, these higher education changes save the state $57 million dollars, and all pension reforms save $425 million.

Summary of the State's Existing Pension Plans

Brief Description of Current Pensions:

As of June 30, 2010, DRS administered eight* statewide public employee retirement systems, which were comprised of 12 defined benefit pension plans and three combination defined benefit/defined contribution plans. There were 1,315 covered employers participating in these systems and/or plans administered by DRS.

Summary table of current benefits in PERS, SERS and TRS; Plans 1, 2 and 3 (representing 92% of active members and annuitants):

Component	Plan 1	Plan 2	Plan 3 (hybrid)
Plans Created	1938-1947	1977	1996-2002
Plans Closed	1977	N/A (open)	N/A (open)
2009 Actives/Annuitants (000s)	15/90	152/25	113/4
Normal Retirement Age/Svc	60/5, Any/30, 55/20	65/5	65/10, 65/"5"
DB Benefit Multiplier	2%	2%	1%
Maximum DB Benefit	60%	N/A	N/A
AFC Period (years)	2HC	5HC	5HC
Vesting Period (years)	5	5	10
Early Retirement (Age/Years)	N/A	55/20	55/10
COLA	Uniform: YOS x $_ Optional: CPI,3%cap	CPI, 3% cap	CPI, 3% cap

*In addition to the three systems identified above; the Public Employees' (PERS), School Employees' (SERS) and Teachers' (TRS) retirement systems; DRS administers the Public Safety Employees' (PSERS), Law Enforcement Officers' and Fire Fighters' (LEOFF), Washington State Patrol (WSPRS), and Judicial (JRS) retirement systems, and the Judges' Retirement Fund (Judges). DRS also administers the state's Deferred Compensation Program (DCP).

Eliminate Automatic Benefit Increases

For PERS Plan 1 and TRS Plan 1

Proposal:

The Governor's proposal would end future automatic benefit increases in the closed plans. This change will eliminate more than one-half of the current unfunded liability in those plans. The Legislature, as was the case prior to 1995, could award cost-of-living increases at its discretion. The repeal would reduce public employer payments by an estimated $9 billion over the next 25 years, with $2 billion of that reduction expected to be realized over the next two biennia.

The proposal would remove the annual increase amount only for members and beneficiaries whose monthly pensions exceed the minimum benefits provided in the plans. Retirees receiving the minimum benefit amounts will not be affected — their benefits will continue to be adjusted annually.

Background:

In 1995, the Washington State Legislature passed an annual benefit increase for members/-beneficiaries in public pension plans, created in the 1930's and 1940's, which had been closed to new members since 1977. While the intent was to provide additional protection from inflation, the automatic increase itself was not linked to inflation, and inflation has been very low for several years. Further, the legislature anticipated that the benefit could have a high cost so they reserved the right to amend or repeal the benefit in the future.

The closed plans for teachers and public employees were identified as the state's only unhealthy pension plans, with funded ratios between 70 and 75 percent, whereas the remaining plans had healthy funding ratios exceeding 116 percent. The two plans had a combined unfunded liability approaching $7 billion as of June 30, 2009. The unfunded liability has been attributed to a combination of two factors over the past 20 years: 1) failure to make recommended contributions, and 2) benefit improvements. Repeal of the 1995 annual increase amount eliminates almost 60 percent of the unfunded liability in the closed plans. It also reduces public employer payments by approximately $9 billion over the next 25 years, with $2 billion of that reduction expected to be realized over the next two biennia.

It is important to keep in mind that this proposal only removes the annual increase amount for members/beneficiaries whose monthly pensions are above the minimum benefits provided in the plans. (The minimum benefits are those whose calculated retirement benefit would fall below either $42.63 per month per year of service or those under certain conditions whose benefit would be less than approximately $1,000 per month.) Retirees receiving the minimum benefit amounts will not be impacted. These benefits will continue to be adjusted annually.

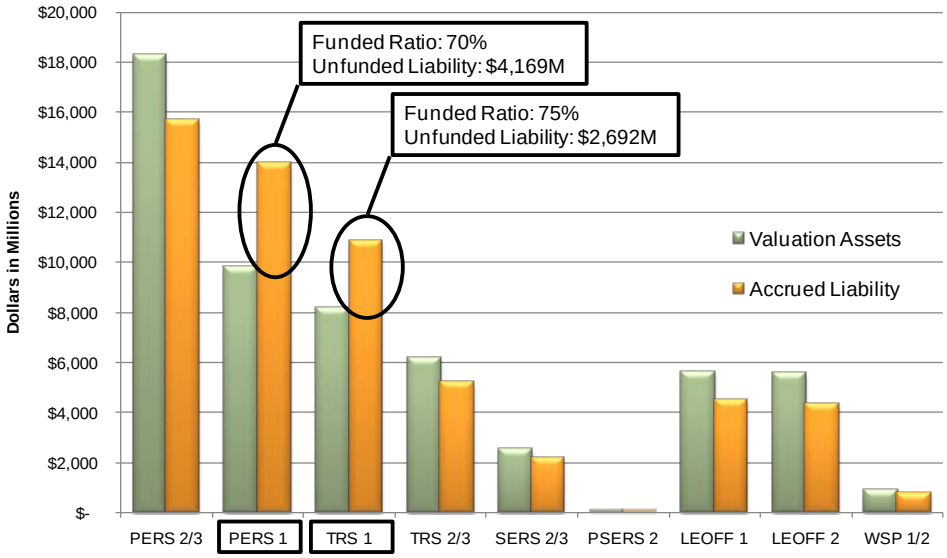
Additionally, as was the case before 1995, this proposal does not prohibit the legislature from granting future "ad hoc" cost of living adjustments if the funding situation has improved in the closed plans and inflation is an issue.

Estimated* Savings:

(Dollars in Millions)	2011-2013	2013-2015	25 Years
General Fund	($349)-($411)	($386)-($554)	($3,461)-($3,726)
Non-General Fund	(108)-(112)	(117)-(156)	(1,095)-(1,303)
Total State	($457)-($523)	($503)-($710)	($4,557)-($5,029)
Local Government	(353)-(392)	(388)-(536)	(3,543)-(4,012)
Total Employer	($810)-($915)	($891)-($1,246)	($8,100)-($9,041)
Total Employee	($0)-($0)	($0)-($0)	($0)-($0)

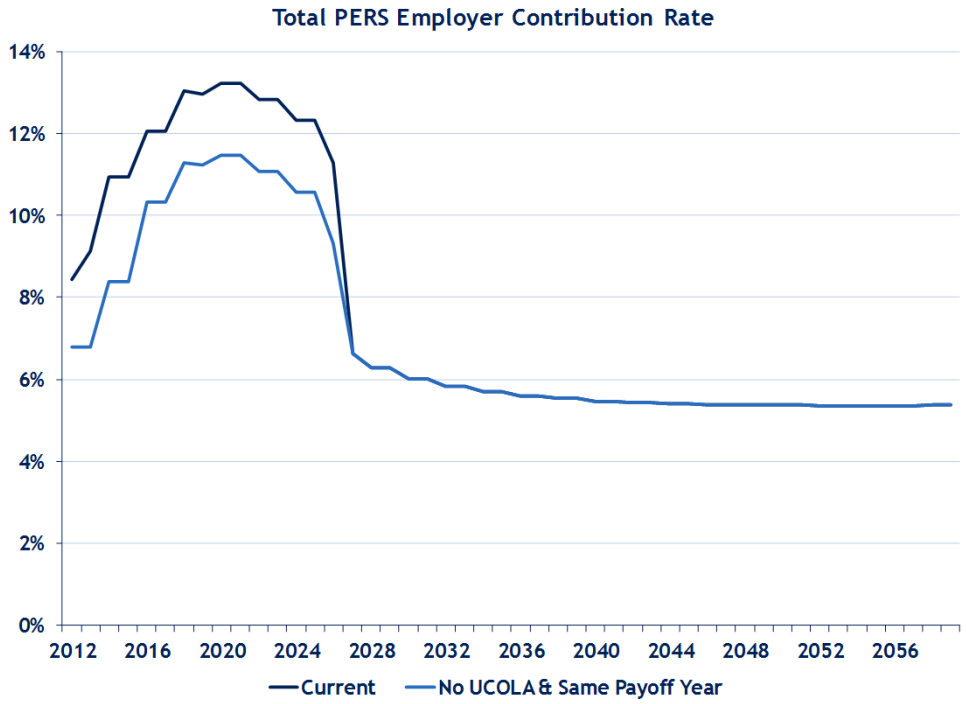
*provided by the Office of the State Actuary, 10/25/10

Plan Assets and Liabilities:



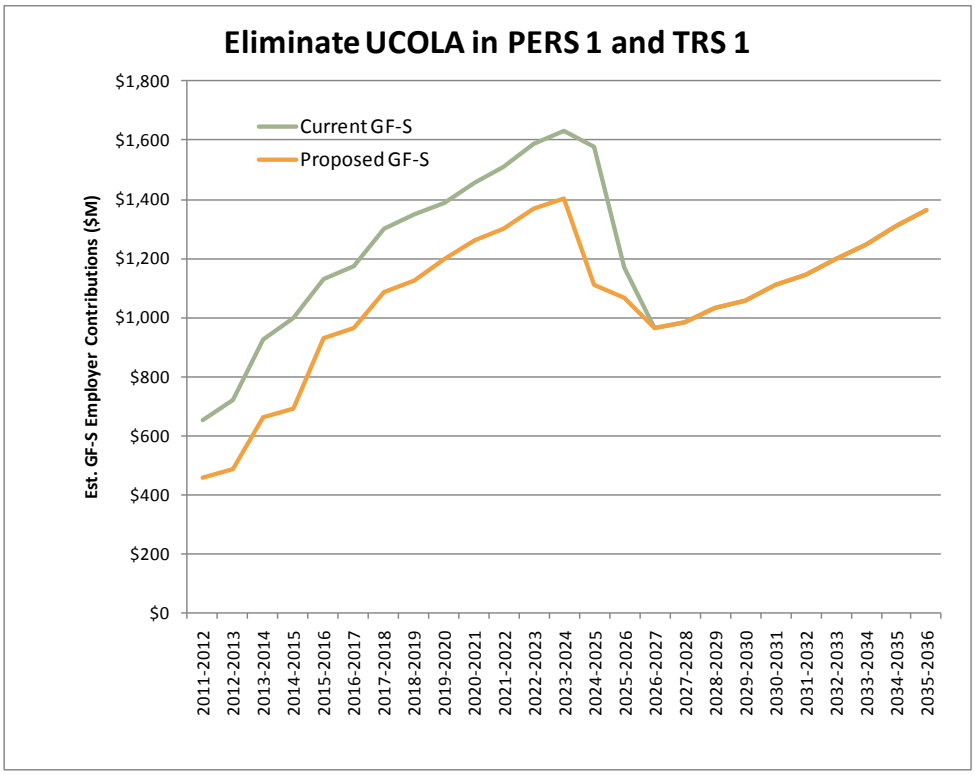
The other systems/plans have Funded Ratios of 116% to 129%.

Estimated Employer Contribution Rates (in PERS):



Both line graphs show that the impact on contribution rates and the resulting GF-S contributions start early but end when the unfunded liability is paid off

Estimated Employer Contributions from the State General Fund (in PERS and TRS Combined):

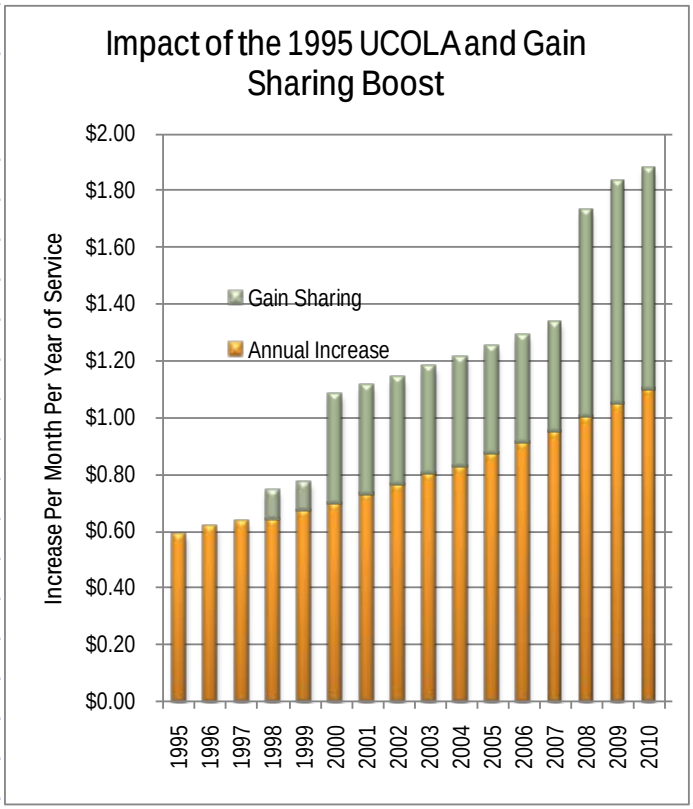


History of Uniform COLA:

Uniform COLA				
Date	Gain Sharing	Annual Increase[1]	Total Increase	Uniform COLA[2]
2010	$0.00	$0.05	$0.05	**$1.88**
2009	$0.05	$0.05	$0.10	**$1.83**
2008	$0.35	$0.05	$0.40	**$1.73**
2007	$0.00	$0.04	$0.04	**$1.33**
2006	$0.00	$0.04	$0.04	**$1.29**
2005	$0.00	$0.04	$0.04	**$1.25**
2004	$0.00	$0.03	$0.03	**$1.21**
2003	$0.00	$0.04	$0.04	**$1.18**
2002	$0.00	$0.03	$0.03	**$1.14**
2001	$0.00	$0.03	$0.03	**$1.11**
2000	$0.28	$0.03	$0.31	**$1.08**
1999	$0.00	$0.03	$0.03	**$0.77**
1998	$0.10	$0.01	$0.11	**$0.74**
1997	$0.00	$0.02	$0.02	**$0.63**
1996	$0.00	$0.02	$0.02	**$0.61**
1995	$0.00	$0.59	$0.59	**$0.59**

[1] The 1995 adjustment of $0.59 is increased by 3%

[2] Per month per year of service.



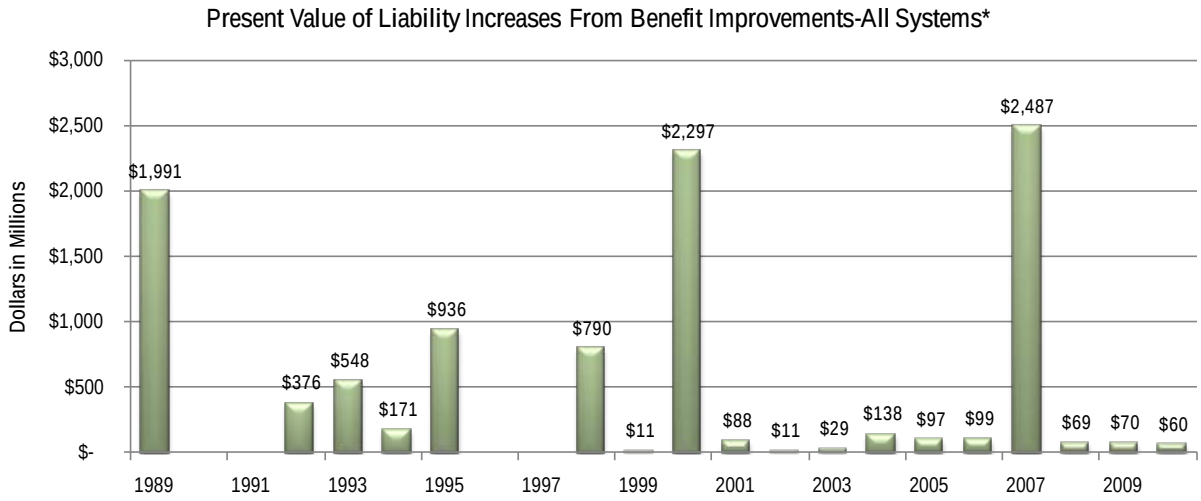
Government Finance Officers Association (GFOA) Advisory on "Responsible Management and Design Practices for Defined Benefit Pension Plans":

In 2010, the GFOA recommended that state and local government plan sponsors use great caution if engaging in the following practices:

3. Retroactive benefits increases. When pension plan sponsors provide retroactive benefits to active employees, the result is an immediate increase in the existing liabilities of the plan. These benefits, related to past service, have not been funded by prior employer or employee contributions. The presumption that a short-term, marketdriven asset surplus makes such benefit enhancements affordable is almost always a critical error that can result in significant underfunding.

5. Ad hoc cost-of-living allowances (COLA) for existing retirees. An ad hoc COLA creates an immediate unfunded liability. COLA increases, like retroactive increases for active employees, should not be paid for with temporary surpluses or extraordinary earnings. Additionally, gainsharing and similar arrangements that allocate short-term returns above the assumed rate to retiree benefits will ultimately impair the plan's funding.

Cost of Benefit Improvements Over the Last 20 Years:



1989 – Plan 1 Age 65 COLA after 40% loss of purchasing power from Age 65.
1995 – Plan 1 Uniform COLA.
1998 – Plan 1 Gain-Sharing.
2000 – Plan 2/3 subsidized early retirement reduction factors with 30 years of service.
2007 – Gain-sharing replacement benefits.

**In 2010 dollars (based on 8% annual interest).*
Note: Does not include impacts of Plan 3 gain-sharing prior to 2008 gain-sharing event. Does not include savings from repealing future gain-sharing since cost never recognized previously.

Projected Employer Contribution Rates:

Employer Contribution Rates (Revised 11/1/10)					
	In Effect	Adopted		Projected	
	(9/1/10 - 6/30/11)	(7/1/11 - 6/30/12)	(7/1/12 - 6/30/13)	(7/1/13- 6/30/14)	(7/1/14- 6/30/15)
	2009-11	2011-13		2013-15	
PERS Plans 1, 2, & 3					
Normal Cost	4.01%	4.70%	4.70%	5.82%	5.82%
Plan 1 UAAL	1.14%	3.75%	4.44%	5.11%	5.11%
DRS Expense Charge	0.16%	0.16%	0.16%	0.16%	0.16%
Total	5.31%	8.61%	9.30%	11.09%	11.09%
TRS Plans 1, 2, & 3					
Normal Cost	4.13%	5.45%	5.45%	6.80%	6.80%
Plan 1 UAAL	1.85%	6.50%	6.85%	8.50%	9.14%
DRS Expense Charge	0.16%	0.16%	0.16%	0.16%	0.16%
Total	6.14%	12.11%	12.46%	15.46%	16.10%
SERS Plans 2 & 3					
Normal Cost	4.15%	5.08%	5.08%	6.44%	6.44%
PERS 1 UAAL	1.14%	3.75%	4.44%	5.11%	5.11%
DRS Expense Charge	0.16%	0.16%	0.16%	0.16%	0.16%
Total	5.45%	8.99%	9.68%	11.71%	11.71%

A significant portion of future contribution rate increases is due to the unfunded liability (UAAL) from Plan 1. That is why reducing the current liability by almost 60 percent, through elimination of the Uniform COLA, has such a significant impact on contribution rates.

Modernize the Public Pensions

(Changes to Plans 2 and 3 for New Hires)

Proposal:

The Governor's proposal would discontinue incentives to retire earlier than age 65 for new hires in Plans 2 and 3 for PERS, TRS and SERS. This modernization of the state's primary pension systems will reduce the long-term cost of public pensions by an estimated $2.2 billion over 25 years for state and local governments, freeing scarce resources for other essential functions.

What are "ERFs?":

If you retire before age 65, your benefit is reduced to reflect the fact that you will receive it over a longer period of time. **The amount of the reduction, also known as the ERF (or Early Retirement Reduction Factors)**, depends on how much younger than age 65 you are when you retire and the amount of service credit you have. The policy being proposed would retain the actuarial reductions for early retirement described in number 1 below but eliminate the subsidized factors in number 2 below.

Plan	Years of Service*	ERF Available
Plan 2	Less than 20	None
	More than 20 but less than 30	Actuarial (#1 below)
	30 or more	3% or 2008 ERF (#2 below)
Plan 3	Less than 10	None
	More than 10 but less than 30	Actuarial (#1 below)
	30 or more	3% or 2008 ERF (#2 below)

*the member must also be at least age 55

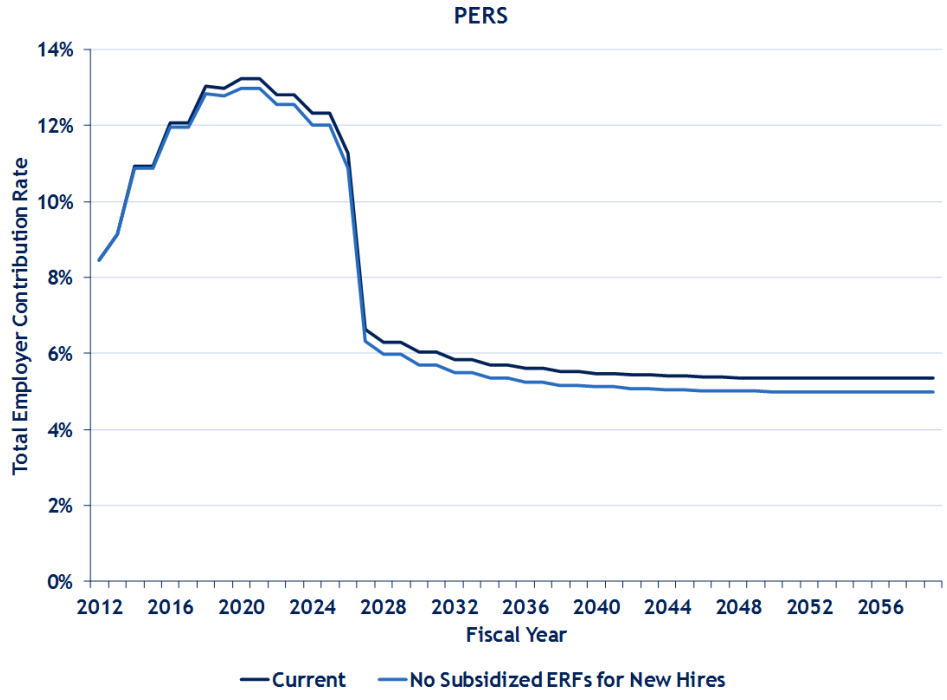
Early Retirement Factors Table			
Retirement Age	At least 10 or 20 years service (#1)	30 years or more service (#2)	
		3% ERF	2008 ERF
55	0.358	0.70	0.80
56	0.395	0.73	0.83
57	0.435	0.76	0.86
58	0.481	0.79	0.89
59	0.531	0.82	0.92
60	0.588	0.85	0.95
61	0.652	0.88	0.98
62	0.724	0.91	1.00
63	0.805	0.94	1.00
64	0.896	0.97	1.00

Estimated* Savings:

(Dollars in Millions)	2011-2013	2013-2015	25 Years
General Fund	$0	($13)-($16)	($782)-($897)
Non-General Fund	0	(5)-(6)	(281)-(332)
Total State	$0	($18)-($22)	($1,063)-($1,229)
Local Government	0	(15)-(18)	(836)-(973)
Total Employer	$0	($33)-($40)	($1,898)-($2,202)
Total Employee	$0	($22)-($27)	($1,242)-($1,441)

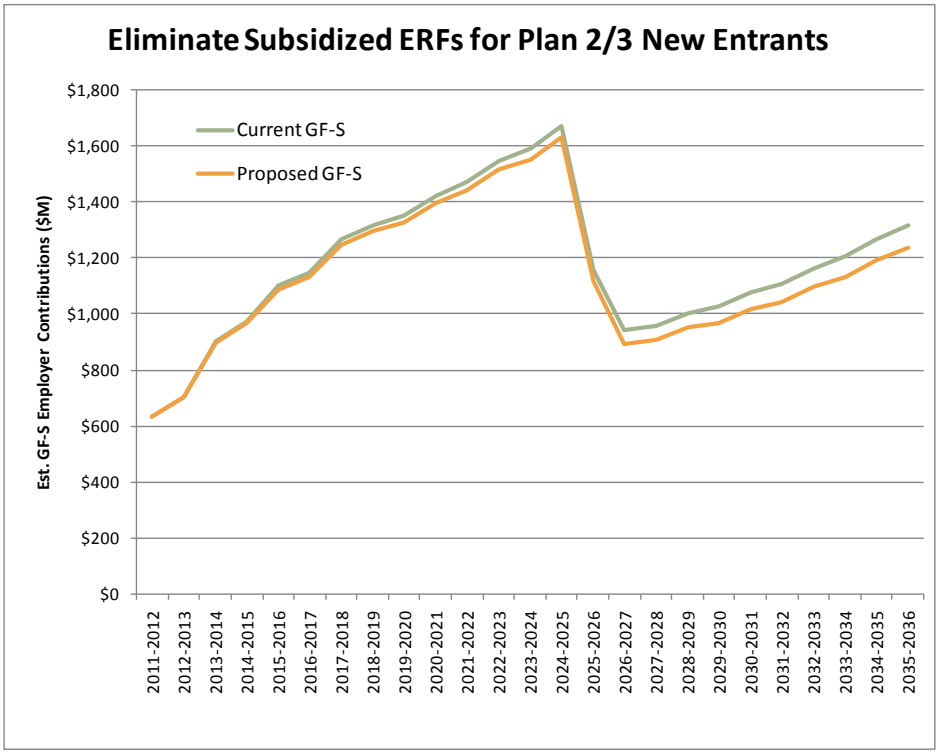
*provided by the Office of the State Actuary, 10/25/10

Estimated Long-Term Impact on Contribution Rates in PERS:



Both line graphs show that the impact on contribution rates and the resulting GF-S contributions start gradually but are ongoing as they apply to new members

Estimated Employer Contributions from the State General Fund in PERS, TRS and SERS Combined:



Reform Higher Education Pensions

Proposal:

The Governor's proposal has two components: 1) to close a retire-rehire exception in higher education and 2) align state contributions.

Closing the retire-rehire exception would disallow retired employees from participating in the separate higher education retirement plans. Restrictions will also be imposed to not allow individuals to draw full-time retirement benefits as well as a salary.

Aligning state support for higher education retirement plans more closely with that provided for other state employees would cap the state's contribution to these plans at 6 percent. Additionally, new higher education employees would be given the option to participate in one of the state's hybrid pension plans instead of the separate plans.

Background:

In 2001, lawmakers expanded the opportunity for retirees from state administered retirement systems to return to work while still receiving their monthly pension. This program was expanded to address recruitment and retention issues, primarily among teachers in hard to fill disciplines, such as math, science and special education. It was feared that many hard to replace teachers who were approaching the benefit limits in the Plan 1 systems would leave to teach in neighboring states, where they could receive a pension and salary. This policy change allowed employers to use experienced retirees as a short-term solution to bridge a recruitment gap for long-term personnel.

In 2003, lawmakers added additional safeguards and limits on the number of hours a retiree could work while still receiving their pension. These additional measures were added to promote employers to use retirees as the original policy intended. These additional safeguards included: lifetime limits on the amount of hours a retiree can work while still receiving their pension, requirements of employers to document a justifiable need to hire retirees, and for the hiring to be approved by the employer's highest level of hiring authority.

Recently, a news article highlighted one area of pension law where an exception to these additional limits and safeguards exists. The exception occurs when a retired public employee returns to work for an institution of higher education and participates in the separate retirement plans offered by the institution. Participation in the other retirement plan exempts them from the limits in the state administered retirement plan. In this situation, the retiree can work and draw full retirement and salary.

The proposed change is to close this exception by disallowing retired employees from participating in these separate retirement plans when they are rehired by a college or university. If they are not participating in the other system, they will be subject to the same limits and safeguards as if they went back to work for any other public employer.

This policy change ensures the state's pension systems are not being used as a means to significantly increase ones salary. The retirement systems were designed to provide secure

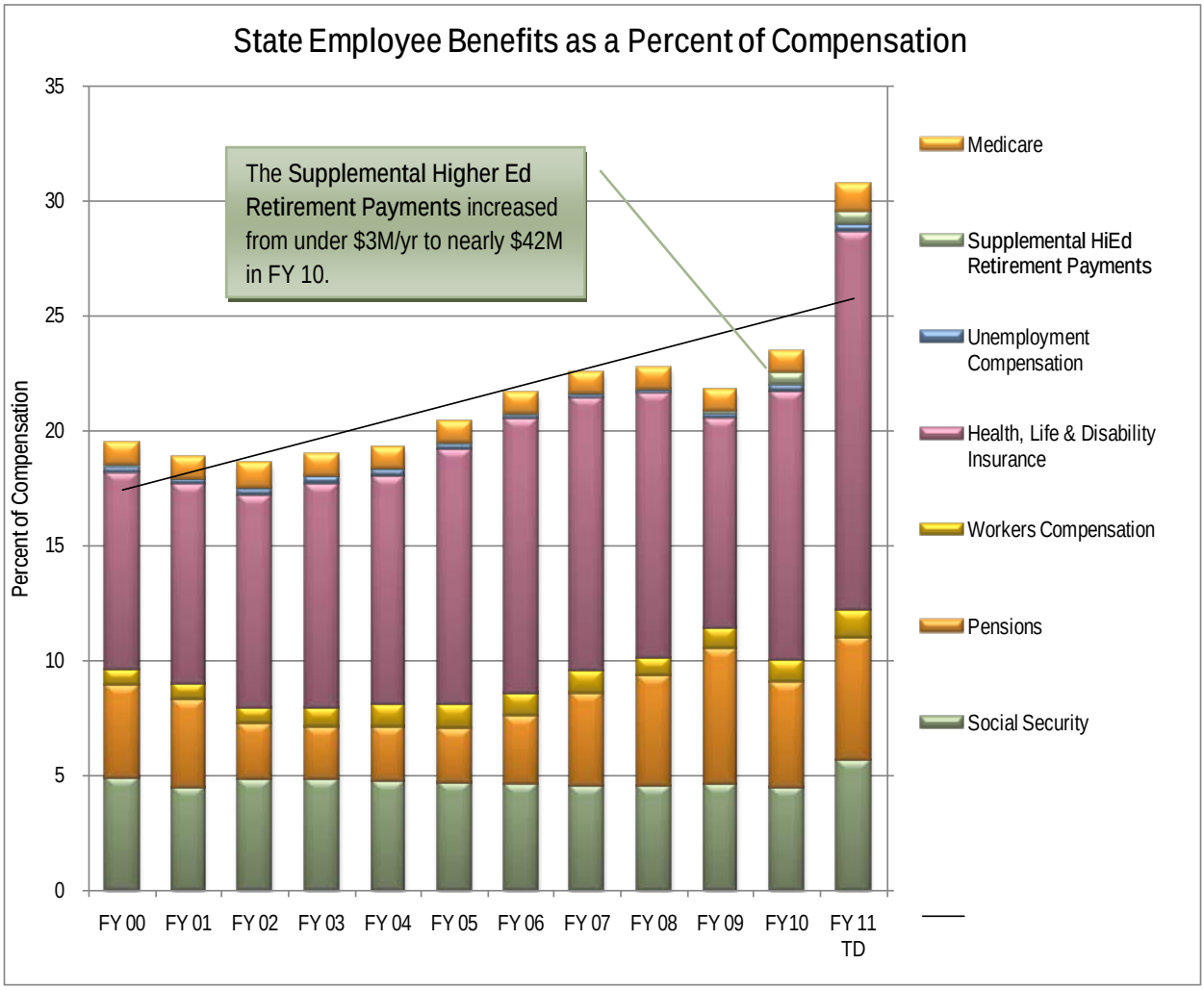
retirement income for employees who were retiring from public service. They were not intended as a long-term supplement to full-time public salaries. By closing this exception, retirees will face the same limits and safeguards regardless of where they return to work in the public sector.

Higher Education Retirement Plan Contribution Rates:

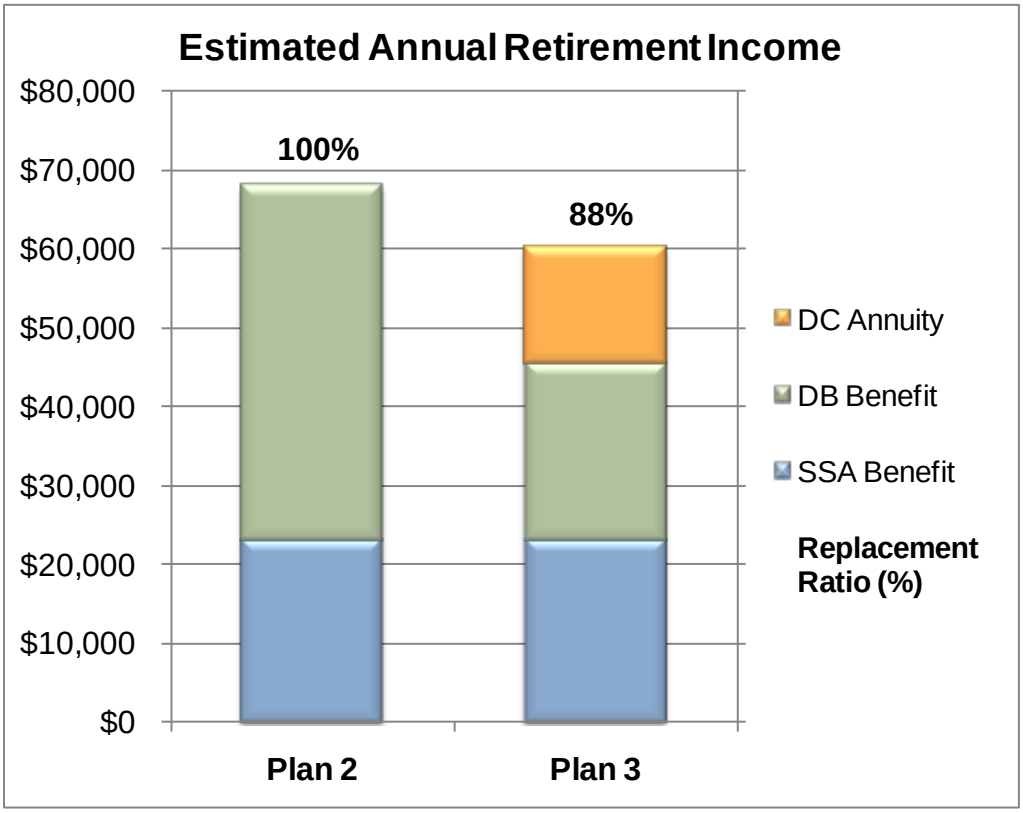
Your Age	Member Contribution	Employer Contribution	Total Contribution
Under 35	5%	5%	10%
35 +	7.5%	7.5%	15%
50 + (optional)	10%	10%	20%

The higher employer contribution rates exceed the normal employer cost in other public employee plans, which is approximately 6 percent.

Employee Benefits as a Percent of Compensation:



Estimated Replacement Ratios:



Assumptions	Plan 2	Plan 3
Retirement Age/Service	Age 65, 30 yrs of svc	
Salary	start = $25k, end = $68k	
Salary Growth	3% per year	
EE Contribution Rate	varies	5%
ER Contribution Rate	varies	
Investment Return	N/A	5% per year