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February 18, 2011

Mr. David L. Senn
Executive Director
Teachers' Retirement System
State of Montana
1500 Sixth Avenue
Helena, MT 59620-0139

Defined Contribution Plan Proposals

Dear Dave:

At your request, we are writing to describe the actuarial impact of potential legislation to place all new hires in defined contribution (DC) plan will have on the Montana Teachers' Retirement System (TRS).

BACKGROUND

The current TRS plan is an Internal Revenue Code (IRC) qualified defined benefit (DB) plan. A DB plan provides a guaranteed lifetime benefit at retirement based on a formula that reflects salary history and service with a covered employer. In contrast, a DC plan does not provide for a guaranteed lifetime benefit. A DC plan is funded by employer (and possibly employee) contributions. These contributions accumulate with actual investment earnings, and the participant's annual retirement income is whatever the accumulated assets can provide over the retiree's lifetime.

In general, DB plans do a better job of providing retirement income whereas DC plans are better at creating retirement savings. Because of the 2008-2009 market downturn, the current approach in the public sector is to consider *replacing* a DB plan with a DC plan. However, there are compelling funding reasons to view them as complementary vehicles that should be offered together.

The ultimate goal of any retirement program is to provide adequate retirement benefits to career employees when they reach normal retirement age. DB plans are the superior vehicle for achieving this goal, as they provide lifetime benefits, and do so in a more cost-effective manner - for any level of employer contribution, a DB plan will provide a greater benefit to a retiree than will the same employer contribution to a DC plan. This is demonstrated on the following page.

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For all pension plans, whether defined benefit or defined contribution, the basic retirement funding equation is:

$$C + I = B + E$$

Where:

- C = employer and member contributions
- I = investment income
- B = benefits paid
- E = expenses paid from the fund, if any.

The underlying message is that dollars in have to equal dollars out. When comparing a DB plan and a DC plan with identical employer contributions ("C"), if investment income ("I") and expenses ("E") are the same, then the *total* benefits ("B") paid from the plans must be equal. However, DC plans are designed to allow members terminating from service prior to retirement to withdraw their account balances which include employer contributions. By contrast when a member terminates prior to retirement under a DB plan with no right to a vested benefit, the employer contributions remain in the system.

Therefore, under a DC plan the benefit paid to a member who terminates prior to retirement is higher than under a DB plan. As a result, a DB plan retains a higher proportion of overall contributions as system assets when members terminate and withdraw prior to retirement; and a decision to move from a DB plan to a pure DC plan will provide lower benefits to employees who serve the citizens of the State for their career, and higher benefits for those employees who terminate after a short period of service in the State.

CURRENT DB/DC ENVIRONMENT

The DB/DC debate has been going on in the public sector for more than a decade. In that time, a number of states have created DC plans for some or all of their employees, including Alaska, Colorado, Florida, Michigan and South Carolina. Others, such as Georgia, Indiana, Oregon and Washington created combined DB/DC plans. Ohio established both a standalone DC plan and a DB/DC combination plan.

A few states, such as Michigan and Washington, offered a choice between the current DB plan and the new DC plan to only existing members. However, the most common approach taken by these states was to offer a choice to both existing members and new hires. Some, like Florida and Ohio, went so far as to allow members to change their elections at specified times in the future.

The experience of the States that offered a choice between a DB plan and a DC plan indicates employees much prefer the DB plan. As well, some states with DC plans have studied the benefits being provided to their members and the employer contribution level, and have concluded that the DC plans are not meeting their retirement goals and are too costly to the employer. Nebraska switched members of the State Employees Retirement System and the County Employees Retirement System from a DC plan to a DB plan. West Virginia recently did the same for participants in the Teachers Retirement System.

ISSUES AFFECTING TRS

In considering whether to establish a DC plan for Montana TRS, there are a number of issues to keep in mind. Foremost is that the current pension benefits may be contractual obligations of the State and may be protected by statute as well as the state constitution. As a result, it may not be possible to cut back or eliminate retirement benefits for existing members. Typically, as is the case with the proposed legislation, changes would only apply to new hires. The current unfunded liabilities for TRS will remain unchanged.

Since new hires will not be joining the current DB plan, the payroll base of the DB plan will begin to decline immediately, so less money will be available to pay down the unfunded liabilities (UAL). Since that base is used to fund the Systems' unfunded accrued liabilities (UAL), the financial burden as a percent of payroll will increase. This will be compounded by Governmental Accounting Standards Board requirements under Statements 25 and 27 to change the payroll growth assumption in financing the UAL to a 5% declining payroll methodology. The impact of this change is in Column A of the attached chart.

The System's stated funding policy is to amortize the unfunded liability over a 30 year period. If TRS were closed to new entrants, as a result of this legislation, we would recommend shortening the amortization period to match the future remaining working lifetime of the active members with the intent of completely amortizing the UAL by the time the last active member retires from the System. On this basis we recommend an 11 year closed amortization period. The impact of this change is in Column B of the attached chart.

The final thing to consider is that the cash flow of TRS would become progressively more and more negative throughout future years. The effect is due to a greater reduction in contributions in future years relative to the reduction in the amount of future benefit payments. Most all mature, ongoing DB plans experience negative cash flow. However, the degree of negative cash flow is usually limited due to new hires replacing those retiring and maintaining a stable flow of incoming contributions. A concern with negative cash flow is that when the degree of negative cash flow exceeds income attributable to interest and dividends earned on the invested assets, assets must be sold to satisfy the need the cash, further reducing the investment return of the System. If legislation to move all new hires to a DC plan were to pass, we recommend close monitoring of cash flow to maintain the alignment of the investment strategy with the short and

long term needs of the System to pay benefits. To demonstrate this fact we have provided the results based on a 4.50% assumed rate of return compared to 7.75% which is currently assumed for the ongoing plan. The impact of this change is in Column C in the attached chart.

Finally, the administrative burden will increase substantially if a DC plan is created. Staffing will have to increase significantly to handle the additional duties of managing the DC plan along with the existing DB plan. DB and DC plans are fundamentally different, so the skill sets that are needed to administer the plan are not the same. In addition, there will be greater communication needs, not only for educational purposes, but also for participant access to the DC plan's account information.

COST IMPACT ON TRS

The employee population covered by a DC plan will be very slow in developing. As a result, even without the added cost factors noted below, it will take many years before the State may begin to realize any cost savings anticipated by creating a DC plan.

In fact, initially employer costs will increase. As noted in a recent National Conference on Public Employee Retirement Systems (NCPERS) white paper:

> "A DC plan must be designed, vendors must be selected, and its operation must be monitored. In addition, employees must be informed about plan features and available investments. Staff time is spent throughout the process, and the sponsoring government must pay additional legal and consulting fees. If a third-party administrator is not hired to administer the plan, the government must do this as well. Even if a third-party administrator is hired, the government will still have operating costs related to the DC plan, possibly ranging in the millions of dollars. For example, the budget for the State of Florida's DC plan, established in 2000, totaled $89 million from FY 2001 through FY 2004. This includes $55 million to educate Florida's 650,000 government employees about the new plan."

In the short term, closing the DB plan to new entrants will require a change in the method used to finance the UAL. Since the UAL does not change when the DB plan is closed, and does not decrease significantly even if existing members are given the option of moving to the DC plan, changing the method will increase the contribution required, at least in the near term. The table provided in Attachment A provides an estimate of the impact on the TRS based on the discussion above. The figures are based on the July 1, 2010 valuation. In the long term, following conversion to a DC plan for new hires, DB plan costs are expected to rise due to the shift in the investment strategy of the remaining asset pool in which benefits will be paid to DB plan participants.

On an ongoing basis, there are additional costs that must be paid for either by the employer or the employee. Administrative expenses are greater for the reasons noted above. Investment expenses are much greater in a DC plan. This is due to the higher cost structure of mutual funds, the typical DC investment vehicle, compared to investment management firms used by DB plans. The NCPERS white paper mentioned earlier noted "According to the Investment Management Institute, the operating expense ratio for DB plans averages 31 basis points (31 cents per $100 of assets) compared with 96 to 175 basis points for DC plans."

CONCLUSION

DC plans are not a panacea. They do provide features not usually found in DB plans, such as portability, investment choice, personal responsibility and lump sum payouts. However, DC plans do not offer the many advantages of a DB plan such as pre-retirement death and disability benefits, post-retirement inflation protection, lower expense ratios and higher average investment returns.

Establishing a DC plan in the State will increase total TRS employer costs in the future, until the employee population is predominantly covered by the DC plan. In order to possibly create these future cost savings, the State will have to lower retirement benefits for the teachers in the DC plan. This in turn will lead to degradation in retirement security for teachers and will negatively affect the overall the State economy.

Certification

This is to certify that the independent consulting actuary is a member of the American Academy of Actuaries and has experience in performing valuations for public retirement systems, that the valuation was prepared in accordance with principles of practice prescribed by the Actuarial Standards Board, and that the actuarial calculations were performed by qualified actuaries in accordance with accepted actuarial procedures, based on the current provisions of the retirement system and on actuarial assumptions that are internally consistent and reasonably based on the actual experience of the System.

Sincerely yours,

Edward A. Macdonald ASA, FCA, MAAA
President

Todd B. Green ASA, FCA, MAAA
Principal and Consulting Actuary

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Attachment A
All Dollar Values are in Millions

	July 1, 2010 Valuation	(A) Decreasing Payroll Amortization	(B) Decreasing Payroll Amortization Over the Future Working Lifetime	(C) Long Term Impact Reflecting 4.50% Assumed Rate of Return
Present Value of Future Benefits	$ 5,115.9	$ 5,115.9	$ 5,115.9	$ 8,440.5
Present Value of Future Normal Cost	(597.7)	(597.7)	(597.7)	(1,783.1)
Actuarial Accrued Liability	$ 4,518.2	$ 4,518.2	$ 4,518.2	$ 6,657.4
Actuarial Value of Assets	2,956.6	2,956.6	2,956.6	2,956.6
Unfunded Actuarial Accrued Liability (UAAL)	$ 1,561.6	$ 1,561.6	$ 1,561.6	$ 3,700.8
Total Normal Cost Rate	9.74%	9.74%	9.74%	22.04%
Employee Contribution Rate	7.15%	7.15%	7.15%	7.15%
Employer Normal Rate	2.59%	2.59%	2.59%	14.89%
Employer Statutory Contribution Rate				
Normal Rate	2.59%			
UAAL Amortization Rate	7.37%			
Total Rate	9.96%			
Amortization Period (Years)	49.5			
Actuarially Determined Contribution Rate				
Normal Rate	2.59%	2.59%	2.59%	14.89%
UAAL Amortization Rate	9.57%	23.77%	31.21%	47.91%
Total Rate	12.16%	26.36%	33.80%	62.80%
Amortization Period (Years)	30	30	11	11
Annual Payroll Growth/(Decrease) Assumption	4.5%	(5.0%)	(5.0%)	(5.0%)

Pension Fund Fiscal Note 2013 Biennium

Bill #	SB0328	Title:	Require PERS new hires to be in DC plan
Primary Sponsor:	Lewis, Dave	**Status:**	As Amended in Senate Committee

Retirement Systems Affected:

- ☐ Teachers
- ☑ Public Employees
- ☐ Highway Patrol
- ☐ Police
- ☐ Sheriffs
- ☐ Firefighters
- ☐ Volunteer Firefighters
- ☐ Game Wardens
- ☐ Judges

Check the box if "Yes".

- ☐ Has this legislation been reviewed by the legislative interim committee?
- ☑ Has the cost of this legislation been calculated by the system's actuary?
- ☐ Does this legislation include full funding for any benefit revisions?

	July 1, 2010 Current System	July 1, 2010 With Changes	Increase/ (Decrease)
Present Value of Actuarial Accrued Liability	$5,241,819,000	$5,241,819,000	$0
Present Value of Actuarial Assets	$3,889,890,000	$3,889,890,000	$0
Unfunded Actuarial Accrued Liability (UAAL)	$1,351,929,000	$1,351,929,000	$0
Amortization Period (years) of UAAL	does not amortize	does not amortize	0.00
Change in normal costs	12.61%	12.61%	0.00%

	FY 2011 July 1, 2010	FY 2012 July 1, 2011	FY 2013 July 1, 2012	FY 2014 July 1, 2013	FY 2015 July 1, 2014
Employee Contribution Rate	6.90%	6.90%	6.90%	6.90%	6.90%
State and Univ Contribution Rat	7.17%	7.17%	7.17%	7.17%	7.17%
State Contribution Rate	0.00%	0.00%	0.00%	0.00%	0.00%
Local Govt Contribution Rate	7.07%	7.07%	7.07%	7.07%	7.07%
State Contribution Rate	0.10%	0.10%	0.10%	0.10%	0.10%
School District Contribution Rat	6.80%	6.80%	6.80%	6.80%	6.80%
State Contribution Rate	0.37%	0.37%	0.37%	0.37%	0.37%
TOTAL Contribution Rate	14.07%	14.07%	14.07%	14.07%	14.07%

FISCAL SUMMARY

	FY 2012 Difference	FY 2013 Difference	FY 2014 Difference	FY 2015 Difference
Expenditures:				
General Fund	$33,971,400	$33,552,000	$33,552,000	$33,761,700
State Special Revenue	$23,101,200	$22,816,000	$22,816,000	$22,958,600
Federal Special Revenue	$15,649,200	$15,456,000	$15,456,000	$15,552,600
Proprietary	$8,942,400	$8,832,000	$8,832,000	$8,887,200
Tuition and Other University	$7,435,800	$7,344,000	$7,344,000	$7,389,900
Local Government and Schools	$72,900,000	$72,000,000	$72,000,000	$72,450,000
Revenue:				
General Fund	$0	$0	$0	$0
State Special Revenue	$0	$0	$0	$0
Federal Special Revenue	$0	$0	$0	$0
Proprietary	$0	$0	$0	$0
Tuition and Other University	$0	$0	$0	$0
Local Government and Schools	$0	$0	$0	$0
Other Pension DB Plan	$162,000,000	$160,000,000	$160,000,000	$161,000,000
Other-Pensions Plan Choice Rate	($1,700,000)	($1,600,000)	($1,400,000)	($1,200,000)
Other-Pensions DC Forfeitures	($234,725)	($234,725)	($234,725)	($234,725)
Net Impact-General Fund Balance:	($33,971,400)	($33,552,000)	($33,552,000)	($33,761,700)

Description of fiscal impact: SB 328 closes the current PERS Defined Benefit (DB) plan and requires that all PERS new hires become members of the Defined Contribution (DC) plan. It eliminates the Plan Choice Rate of 2.37% and replaces it with the additional contribution of 0.27%. The elimination of the forfeitures will require plan membership fees to increase, thus providing less money to member accounts. DC plan forfeitures are eliminated, therefore, requiring increased fees for participants and providing less money to

member accounts. The closing of the DB plan will be a very costly proposal since liabilities do not go away until the last DB member or contingent annuitant dies.

FISCAL ANALYSIS

Assumptions:

Public Employees Retirement Division

1. The presentation of the actuarial results for the Unfunded Liabilities is as if the bill had been effective as of June 30, 2010.
2. For purposes of the projections, the actuary assumed an effective date of July 1, 2011.
3. Employees hired after the effective date would no longer be eligible for the PERS defined benefit plan (PERS-DB), but would be eligible to become members of the PERS defined contribution plan (PERS-DC).
4. Non-vested members in PERS-DB would be eligible to elect and transfer to PERS-DC.
5. The current 5 year vesting for the PERS-DC is eliminated so members would be immediately vested in the employer contributions.
6. The impact regarding disabilities would be minimal since the bill was amended to require 5 year vesting before applying for a disability.
7. All current members of PERS-DC would become immediately vested in the employer contribution account.
8. The number of active employees eligible for either PERS-DB or PERS-DC will remain constant from the June 30, 2010 actuarial valuation.
9. The contribution rate for employees, employers, and the state will remain the same; all excess costs (normal cost plus the unfunded actuarial liability above the statutory contribution rate) must be included in the Governor's 2015 Biennium Budget Recommendations.
10. PERS assumed that transfers of existing non-vested members will be minimal and will not have a material impact on our results.
11. Additional contributions are allowed beyond the statutory contribution rate.
12. If any funding required by Section 4 of the bill to be submitted by the Governor in the Executive Budget were not approved by the Legislature, the employer rate for the DB plan would be expected to increase to 60.1% by 2030. If no funding were provided – either by a Governor's proposal or by increasing the employer contribution rate, the employer rate would be projected to increase to over 200% by 2030.
13. Allocations of the employer contribution in PERS-DC have been modified.
14. The sunset provisions related to the DB employer contribution of 0.27% of payroll are eliminated and this contribution amount has become permanent.
15. The plan choice contribution rate of 2.37% of payroll is eliminated. However, there will be a plan choice contribution equal to 0.27% of payroll on what will become a larger payroll in the PERS-DC plan.
16. DC plan forfeitures are eliminated, therefore, requiring increased fees for participants and providing less money to member accounts.
17. Since the changes in benefits affect future employees only, there would be no effect in the normal cost rates or in the actuarial liability as of June 30, 2010.
18. There would be a change in the UAL contribution rate due to the closing of the plan to new employees.
19. The current amortization rate is based upon an "open" 30-year amortization of the UAL as a level percentage of future payroll assuming future annual payroll increases of 4%. By "open" amortization, it is meant that at each valuation date, a new 30-year period is established such that, in theory, the UAL would never be fully amortized. With the closing of the plan, there will no longer be an increasing payroll for this amortization, but rather a decreasing payroll. Therefore, the amortization method has been changed to a level dollar amortization.

20. Due to the closing of the plan, it would no longer be reasonable to use an open amortization method. Therefore, the amortization method has been changed to a fixed 30-year period starting on the effective date.
21. The total payroll will increase at the assumed rate of 4.0%.
22. All actuarial assumptions will be realized, including the investment return assumption of 7.75%.
23. The fiscal impact presented in the report assumes that this bill is the only amendment being considered. If other changes are also adopted, the fiscal impact associated with this bill could be different.
24. There have been no adjustments for actuarial gains and losses or for changes in membership or financial data since the last valuation as of June 30, 2010.
25. The provisions would become effective upon receiving a favorable determination letter from the Internal Revenue Service.
26. There is a requirement to include in the budget those amounts that will amortize the PERS-DB unfunded actuarial liability (UAL).

Governor's Budget Office

27. Section 4 requires the Governor's Budget Office to have *"detailed recommendations for the amount of funding and source of funding necessary to amortize the unfunded liabilities of the retirement system provided for in title 19, chapter 3, within the time period determined by the public employees retirement board."*
28. The fiscal note assumes a 30 year amortization period - however the public employees' retirement board would make the recommendation and it could be a lower amount.
29. There are no statutory employer contributions in the bill.
30. Either the state would have to fund the liability with general fund directly or seek statutory changes to employer contributions. Although the bill does not require the Governor's Budget to include a funding proposal until the 2015 biennium, this fiscal note assumes a statutory employer contribution increase starting in the 2013 biennium. However, legislation would be required to do so. If the funding did not start until the 2015 biennium, the cost of SB 328 would be significantly higher.
31. The following is the funding allocation that would apply if a employer contribution rate were to occur based upon the costs of SB 328:
    a. 46% of the costs would be attributable to state agencies, 9% to the Montana University System (MUS), and 45% would be for local governments and school districts.
    b. Utilizing MBARS data, PERS employees in state government are funded approximately 36% from the general fund, 31% from state special revenue, 21% from federal special revenue, and 12% from proprietary funds.
    c. Approximately 58% of the Montana University System employees are paid from the current unrestricted fund and 42% are paid from other funds.
    d. For the 2013 Biennium, the Executive Budget funds the current unrestricted funds 84% from the general fund and 16% from tuition for present law adjustments.
    e. Local Governments, including school districts would be expected to pay their own costs and not be borne by the state.

Fiscal Impact:	**FY 2012 Difference**	**FY 2013 Difference**	**FY 2014 Difference**	**FY 2015 Difference**
Expenditures:				
Personal Services	$162,000,000	$160,000,000	$160,000,000	$161,000,000
TOTAL Expenditures	$162,000,000	$160,000,000	$160,000,000	$161,000,000
Funding of Expenditures:				
General Fund (01)	$33,971,400	$33,552,000	$33,552,000	$33,761,700
State Special Revenue (02)	$23,101,200	$22,816,000	$22,816,000	$22,958,600
Federal Special Revenue (03)	$15,649,200	$15,456,000	$15,456,000	$15,552,600
Proprietary (06)	$8,942,400	$8,832,000	$8,832,000	$8,887,200
Tuition and Other Univ. (3X)	$7,435,800	$7,344,000	$7,344,000	$7,389,900
Local Goverment and Schools	$72,900,000	$72,000,000	$72,000,000	$72,450,000
TOTAL Funding of Exp.	$162,000,000	$160,000,000	$160,000,000	$161,000,000
Revenues:				
General Fund (01)	$0	$0	$0	$0
State Special Revenue (02)	$0	$0	$0	$0
Federal Special Revenue (03)	$0	$0	$0	$0
Proprietary (06)	$0	$0	$0	$0
Tuition and Other Univ. (3X)	$0	$0	$0	$0
Local Goverment and Schools	$0	$0	$0	$0
Other-Pensions Plan Choice Rate	(1,700,000)	(1,600,000)	(1,400,000)	(1,200,000)
Other-Pensions DC Forfeitures	(234,725)	(234,725)	(234,725)	(234,725)
Other - Pension DB	$162,000,000	$160,000,000	$160,000,000	$161,000,000
TOTAL Revenues	$160,065,275	$158,165,275	$158,365,275	$159,565,275
Net Impact to Fund Balance (Revenue minus Funding of Expenditures):				
General Fund (01)	(33,971,400)	(33,552,000)	(33,552,000)	(33,761,700)
State Special Revenue (02)	(23,101,200)	(22,816,000)	(22,816,000)	(22,958,600)
Federal Special Revenue (03)	(15,649,200)	(15,456,000)	(15,456,000)	(15,552,600)
Proprietary (06)	(8,942,400)	(8,832,000)	(8,832,000)	(8,887,200)
Tuition and Other Univ. (3X)	(7,435,800)	(7,344,000)	(7,344,000)	(7,389,900)
Local Goverment and Schools	(72,900,000)	(72,000,000)	(72,000,000)	(72,450,000)
Other-Pensions Plan Choice Rate	(1,700,000)	(1,600,000)	(1,400,000)	(1,200,000)
Other-Pensions DC Forfeitures	(234,725)	(234,725)	(234,725)	(234,725)
Other - Pension DB	162,000,000	160,000,000	160,000,000	161,000,000

Effect on Local Governments:

1. The number of active employees eligible for either PERS-DB or PERS-DC will remain constant from the June 30, 2010 actuarial valuation.
2. The contribution rate for employers and the state will remain the same.

3. If the Unfunded Actuarial Accrued Liability (UAAL) were amortized and funded over 30 years, the following costs would be incurred by local governments.

FY 2012	FY 2013	FY 2014	FY 2015
$72,900,000	$72,000,000	$72,000,000	$72,450,000

Long-Term Impacts:

1. The liability for the current DB members does not go away and, in fact, the costs increase until the time that no benefits are due to retirees or their contingent annuitants.

Technical Notes:

Public Employees Retirement System

1. The funding source for the plan changes is not identified.
2. If the plan does not obtain the funding assumed by the actuary, the DB plan will be insolvent in 20 years as a result of this bill.
3. The disability trust fund will not be sufficient over time.
4. The current plan choice rate unfunded actuarial liability (PCR-UAL) is $14,687,168. This is the outstanding, unpaid UAL left behind when current members at plan implementation had the option to choose between the PERS-DCRP and the PERS-DBRP. This proposal repeals the PCR that would pay down this liability and assumed it will be a part of the Governor's budget.
5. "Additional contributions" that are allowed in the bill are undefined.
6. An election is allowed for "certain members" – non-vested members. This may be an equity issue.
7. If the definition of "initially hired" were included in Title 19 Chapter 3 rather than Chapter 2, which addresses all retirement plans administered by the PERB, it would be more clear.
8. The rate of 8% is the rate for the original transfer period for current members, many of which were long-time PERS members. This rate should not be more than the actuarial assumed rate of return of 7¾%.
9. The plan choice rate (PCR) is repealed. The PCR pays the impact on the unfunded actuarial liability due to members leaving the defined benefit plan. The proposal does allocate 0.27% of employer contributions to the DBRP and to the long-term disability plan trust fund. However, the language "in the following order" is removed. It is unclear how it should be allocated.

Sponsor's Initials	*Date*	*Budget Director's Initials*	*Date*