Montana's Pension Challenges

Montana's pension system is on an unsustainable course. The state has failed to set aside enough money to fund the pension promises it has made, and by 2012 its retirement systems were collectively only 64 percent funded. If not addressed, Montana's growing pension debt of $4.3 billion will threaten public workers' salaries and benefits and will crowd out other essential state services.

To bring the state's pension plans up to full funding and make them sustainable in the long-term, lawmakers will need to make substantial reforms. The state's own analysis found that if Montana does not change how it manages its retirement systems, the pension debt that is owed to workers and retirees will never be funded.[1] The longer Montana waits to address the structural challenges within its pension system, the larger and more difficult the problem becomes.

Montana's Retirement Systems

Montana administers eight traditional defined-benefit pension plans. The two largest are the Public Employees' Retirement System, or PERS, and the Teachers' Retirement System, or TRS. More than 90 percent of all public workers in Montana participate in one of these two plans. Together they represent a pension debt of nearly $3.8 billion, 88 percent of the total owed by state and local governments. Alarmingly, our actuarial analysis of PERS and TRS reveals that, under current plan assumptions, the state's largest plans will run out of money without a change in either contribution policy or plan benefits—in 2042 for the teacher's plan and by 2047 for the state employees' plan.[2]

Although smaller in size, the remaining six traditional defined-benefit retirement plans administered by the state are in a similar position. Collectively in fiscal 2012, these plans had a pension debt of roughly $495 million and only 65 percent of the assets needed to cover the cost of workers' earned benefits.

The Public Employees' Retirement System

In 2012, PERS, the largest retirement system in Montana, faced an unfunded liability of $1.8 billion. From 2008 to 2012, its pension debt grew by roughly $1.4 billion, representing a decrease from 90 percent funded to only 67 percent funded in four years. Although the plan's actuarial assumptions are based on a 7.75 percent investment rate of return, the plan's actual annualized return for the last 10 years was only 7 percent.

The current funding structure of PERS is not fiscally sound even if the plan achieves a 7.75 percent return going forward. Unless public employers in Montana commit to making the full recommended contributions or policymakers require benefit cuts to existing employees and retirees, the plan will eventually run out of money, immediately forcing a significant increase in contributions to make benefit payments to retirees.

The Teachers' Retirement System

Montana's second-largest retirement system faces similar difficulties. In 2012, TRS had an unfunded liability of nearly $2 billion, and the retirement system was only 59 percent funded. Unlike PERS, which was well-funded as recently as 2003 and has since had a sharp drop, the teachers' pension plan has faced substantial funding gaps for years. As of the most recent actuarial valuation, TRS reported that the current schedule of contributions will not be sufficient to fully pay off the pension debt over a 30-year period. Our actuarial projections based on TRS data and assumptions show that the plan is projected to run out of money in 2043 without a change in policy (See Exhibit 1).

What Went Wrong?

Montana has not always had a funding problem. In 2000, the state's pensions had a $244 million surplus, but by 2012 there was a $4.3 billion deficit. How did this happen? The state has repeatedly increased pension benefits without paying for those commitments and failed to require that public employers make adequate pension contributions. This underfunding coupled with investment returns that have fallen short of plan assumptions have created a substantial financial burden that for years to come will affect public workers, taxpayers, and everyone who depends on government services like schools and roads.

Although the Great Recession certainly made Montana's unfunded liability worse, it wasn't the cause of the problem. In 2007 before the

EXHIBIT 1: PENSION FUNDING LEVELS BY PLAN, 2012

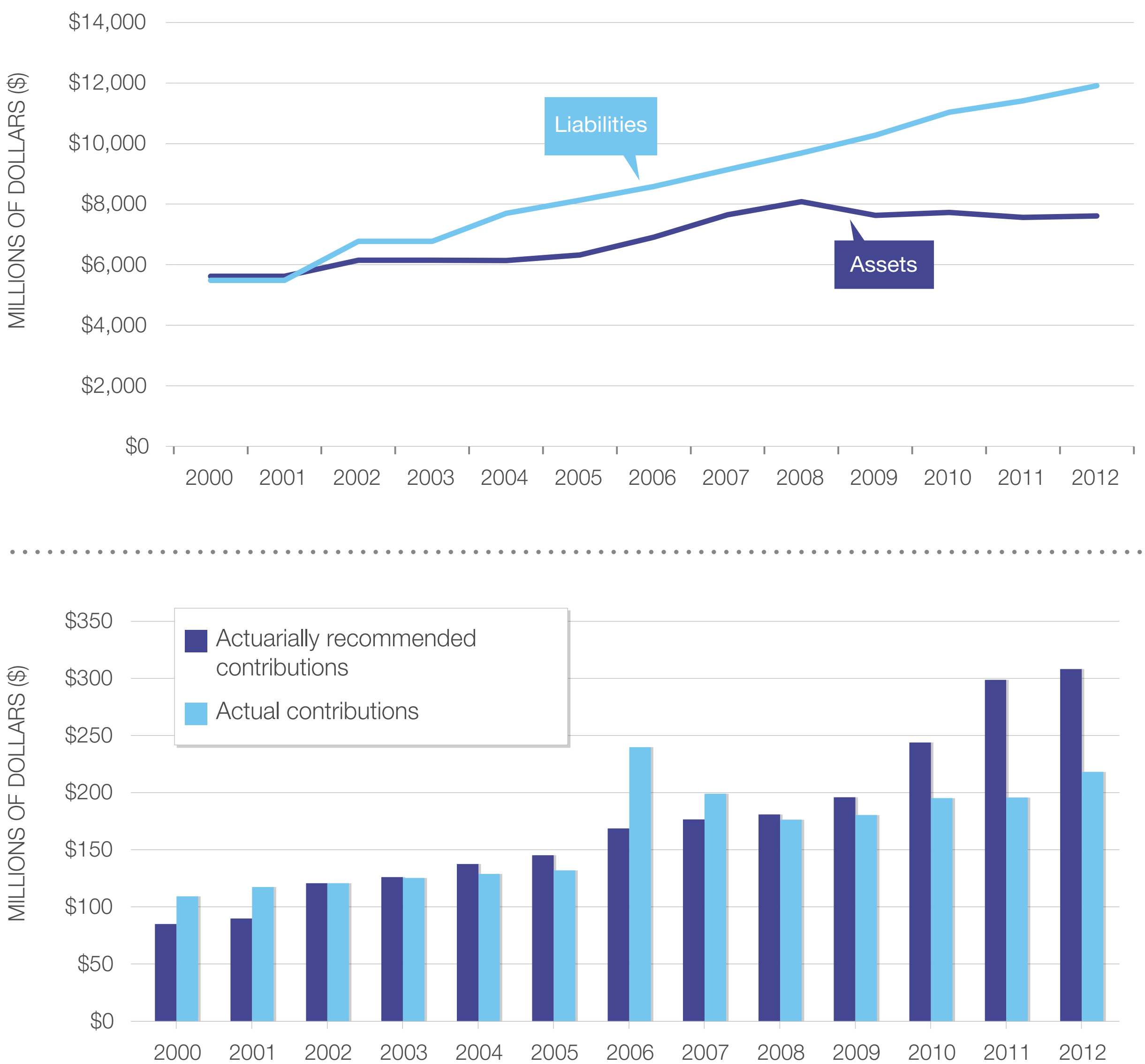
All numbers in millions of dollars

Plan	Assets	Liabilities	Unfunded Liability	Percent Funded	Share of Unfunded Liability	Annual Recommended Contribution	Actual Contribution	Percent Contributed
Public Employees' Retirement System	$3,817	$5,661	$1,844	67%	48%	$148	$78	52%
Teachers' Retirement System	$2,852	$4,815	$1,963	59%	40%	$109	$89	82%
Sheriffs' Retirement System	$212	$285	$73	74%	2%	$10	$6	63%
Highway Patrol Officers' Retirement System	$97	$168	$71	58%	1%	$6	$5	86%
Game Warden and Peace Officers' Retirement System	$98	$129	$31	76%	1%	$5	$3	71%
Firefighters' Unified Retirement System	$233	$377	$144	62%	3%	$13	$17	128%
Municipal Police Officers' Retirement System	$234	$427	$193	55%	4%	$17	$18	106%
Judges' Retirement System	$63	$46	-$18	137%	0%	$0.1	$2	1163%
Totals	**$7,605**	**$11,908**	**$4,303**	**64%**	**100%**	**$308**	**$218**	**71%**

recession started, Montana had already accrued a $1.5 billion pension shortfall. Just as the Great Recession was not the cause of the unfunded liability, the state cannot simply rely on a recovering economy to grow its way out of its current pension debt. Doing so would require plan investment returns to exceed the assumed rate of return over a sustained period, a risky gamble to make with workers' benefits. Offering a traditional pension plan in a sustainable way requires consistent, ongoing funding discipline, not a lucky roll of the dice.

Paying down the pension debt will not be easy. The current unfunded liability is equal to half the state's annual spending for all government services. To pay off this debt right now, every Montana household would have to contribute $10,600 to the retirement system. And without significant state action, this bill will only get bigger (See Exhibit 2).

EXHIBIT 2: MONTANA RETIREMENT SYSTEM PENSION FUNDING AND CONTRIBUTIONS OVER TIME



Montana Frequently Misses Annual Payments

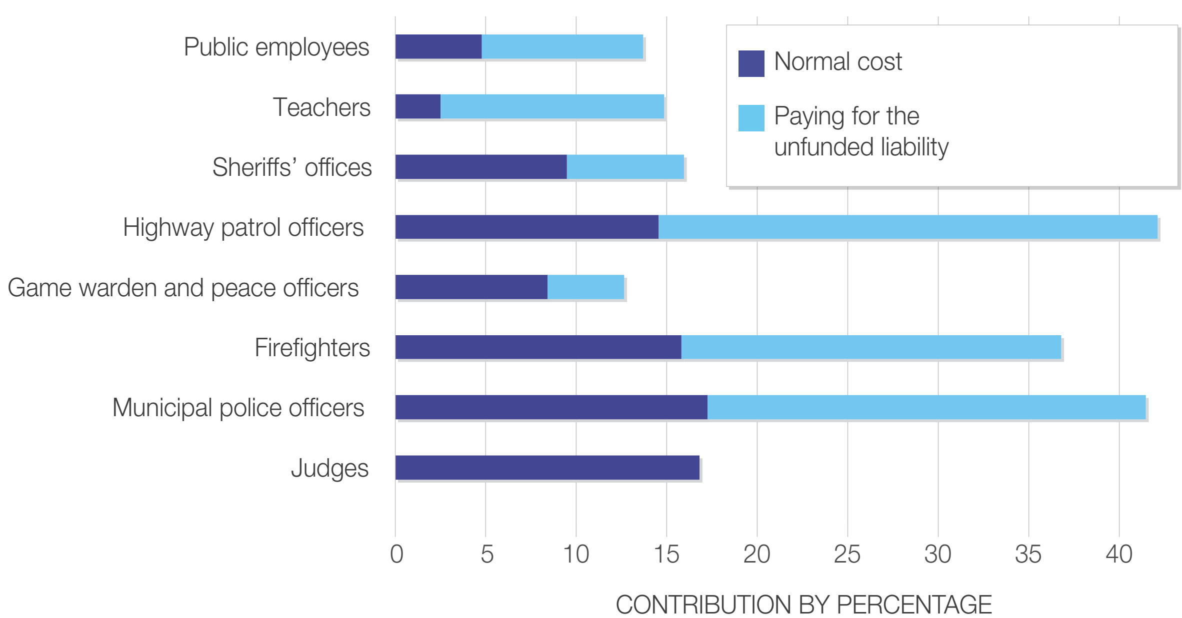
A major contributing factor to the steep increase in the state's pension debt has been Montana's lack of commitment to fully funding worker benefits. It has not made its full annual recommended contribution in seven of the past 11 years. Similar to an individual who makes the minimum payment on a credit card bill, when the state fails to make the full required payment, the pension debt grows dramatically, as do the necessary payments.

From 2005 to 2012, the annual recommended contribution, or ARC, for Montana's pensions doubled while the state's actual contributions to its retirement systems grew by only a little over half. For the Public Employees' Retirement System, just 52 percent of the annual required contribution was made in 2012. And while public employers have a better track record of making full payments to the Teachers' Retirement System, recent contributions to that plan have also fallen short—only 82 percent of recommended payments were made in 2012. As a result of repeatedly underfunding the ARC, a large and growing portion of current pension contributions is now being used to pay for past service. In 2012, 33 cents of every dollar Montana put into PERS went to pay for past promises instead of benefits earned in that year (See Exhibit 3).

Montana's employer contributions have remained relatively low despite the rising pension cost because the contribution levels have been statutorily fixed for years. By law, the PERS employer contribution rate is 7 percent of payroll, and the TRS employer contribution rate is 9.85 percent. These fixed rates are not based on any analysis of the actuarial cost of Montana's retirement benefits and have been inflexible when reality did not match plan assumptions. As a result, contribution rates have fallen short of what is needed to fund promised benefits.

Unless the fixed statutory contribution rates are changed to allow them to rise with benefit costs, the pension debt will continue to grow even if plan assumptions are met. We project that between 2014 and 2041, PERS' contributions required under current law will fall short of the

EXHIBIT 3: FOR RETIREMENT SYSTEMS, MUCH OF THE ACTUARIALLY APPROPRIATE CONTRIBUTION RATE IS TO PAY FOR PAST PROMISES



responsible annual recommended contribution amounts by an additional $1.7 billion, leading the current debt to balloon. As the pension debt grows, the state will be forced to put significant additional resources into the retirement system, probably at the expense of workers' salaries and essential state services.

In the end, offering a traditional pension benefit requires making many predictions; if those forecasts are wrong, the state can get hit with unexpected cost increases that are difficult to absorb. Because pension plans depend on investments to fund the majority of employee benefits, retirement costs increase when the economy struggles. Employers are also asked to kick in more when they are facing declining tax revenue and budget cuts. The result has been predictable—missed payments and growing shortfalls.

This has played out in Montana. Since 2000, lower investment returns have added $1.6 billion in pension debt to the PERS plan and $1.2 billion to the TRS plan. Combined with $488 million in unfunded benefit increases in 2001, this rapidly growing pension debt has led to a steep rise in the necessary contributions that state and local employers should pay into Montana's pension plans. From 2000 to 2012, Montana's annual recommended contribution more than tripled from $84 million to more than $308 million. In 2000, the state's recommended contribution represented only 6 percent of payroll; by 2010 it equaled 19 percent. The statutory contribution rates, however, did not keep pace. The result is a pension debt that has grown to equal about half of all state spending.

The state's failure to consistently make the necessary full annual contributions jeopardizes the overall health of Montana's pension plans and thus the security of worker benefits. As costs are deferred further and annual payments become increasingly large, policymakers are

WHAT IS A LIABILITY, AND WHY FUND IT?

A pension plan's liability is an estimate of the current value of benefits that workers have earned to date. To ensure that benefits can be paid in full and that the cost of services delivered today is not pushed into the future, retirement plans should have assets on hand that fully cover estimated liabilities.

A retirement plan's estimated liability depends on a number of assumptions. While the most critical is the assumed rate of return on investments, many other assumptions are also important, including how long plan recipients are likely to live, what their future salaries will be, and when they will retire. As long as participating employers make the full recommended contribution, policymakers don't raise benefits without paying for them, and the plan relies on accurate actuarial assumptions, a plan's assets should closely match liabilities.

Events such as the recent global financial crisis may lead to temporary dips in asset values, but fiscally responsible states will take swift corrective action to bring assets and liabilities back into alignment. Employees expect to receive the full retirement benefits that they have been promised, and states should take their responsibility seriously to fully fund those benefits.

WHAT IS AN ARC AND WHY SHOULD IT BE PAID?

The annual recommended contribution is the amount that public employers should contribute to a retirement plan each year to ensure that workers' benefits will be fully funded. An ARC has two parts: the normal cost and the pension debt payment. The normal cost is the amount needed to pay for the benefits workers earned in a given year. The ARC includes the pension debt payment is an amount paid on existing pension debt over a time period, often 30 years.

A fiscally responsible state pays 100 percent of its recommended contribution each year. Failing to do so underfunds workers' benefits and accumulates additional debt by pushing the cost into the future.

unfairly forcing future generations of workers and taxpayers to bear the consequences.

Pension Challenges Require Quick Action

The longer Montana delays addressing its pension funding problem, the bigger the problem gets and the more painful the available remedies become. Ultimately, the benefits that workers have earned must be paid for. Ignoring the problem until it becomes a crisis should not be an option for the state. A closer look at Montana's two largest plans illustrates the consequences of doing nothing.

Based on current policy, we project that in 2046 contributions to PERS will total $574 million. By the next year, the plan will have run out of money, meaning worker benefits will need to be funded on a pay-as-you-go basis—requiring a sudden increase in annual payments that would more than double to $1.3 billion. Similarly, payments to TRS are projected to be $305 million in 2041 under current policy.

But when TRS runs out of money in 2042, annual payments would swiftly grow to more than $600 million. The increased contributions necessary under these scenarios would come from Montana's future public workers through lower salaries and fewer jobs and from taxpayers through higher taxes and reduced services. Alternatively, benefits promised to existing employees and retirees would have to be cut. These scenarios of extreme fiscal crisis are not the result of what might happen under a doom-and-gloom economic forecast, but rather what will occur if current state policy is maintained and all plan assumptions are met (See Exhibit 4).

State's Pension Plans Face Structural Problems

Montana must address a few challenges that stem from the structure of its current retirement system to place it on a sustainable footing. First and foremost, the state's current pension plans make it difficult to accurately predict the cost of benefit promises and allow costs to be indefinitely pushed to future years, two of the primary drivers of Montana's current pension debt. Simplifying the cost structure and making it easier to transparently calculate benefit cost would be a big improvement.

Second, the pension plans have exposed the state to more risk than it has shown itself able to handle. Closing the funding gap is an important step, but reform must also ensure that, going forward, Montana's pension plans do not experience unmanageable cost increases and accumulate unfunded liabilities that would threaten workers' benefits or the state's fiscal health. Dialing back assumptions, such as projected investment returns, to more conservative values would lessen the risk that a traditional defined-benefit plan ends up underfunded, but doing so would also increase the necessary payments to prefund benefits.

Putting more money aside now to fund future benefit payments may be prudent state policy, but doing so without improving the predictability and transparency of the cost of benefits would maintain much of the risk resulting from the current pension debt. And no amount of risk is manageable as long as the state continues to avoid making full pension payments.

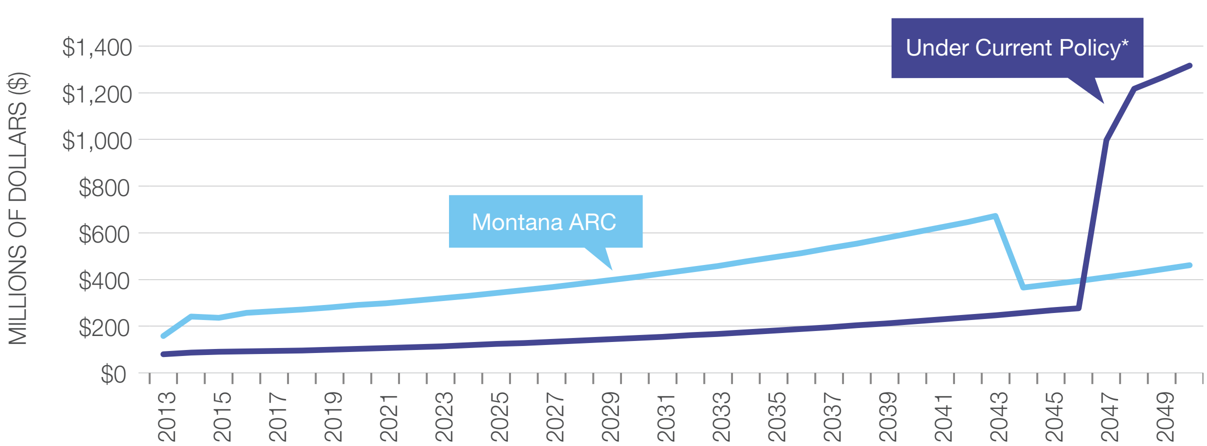
The plans' assumed investment returns offer an illustration of the risk that Montana's current retirement system promises place on future workers and taxpayers. The state's pension plans assume that their investment returns will average 7.75 percent over the long-term. We estimate that if Montana begins fully funding the annual recommended contribution to PERS starting in fiscal 2014, the total current value of the contributions needed from public employers between 2014 and 2024 would be $1.28 billion.

Under a more pessimistic scenario, if investment returns were instead just 6.25 percent, then employers would have to put aside 20 percent more to meet the contribution requirements even as the plans' funding would drop to just 69 percent funded, leaving a significant burden on future workers and taxpayers. And this assumed return is just one of the many predictions that must be correct for pension costs to match expectations. If people live longer than expected, make more money than expected, or don't retire at the expected times, the price gets bigger.

Third, the traditional defined-benefit plan currently offered by the state backloads benefits and is relatively inflexible to workers' preferences for differing retirement ages and benefit structures. Benefit backloading refers to the way workers earn their benefits throughout their careers. In the traditional defined-benefit system, workers earn most of their pension benefits late in their career, resulting in an inherent inequity for early- and midcareer workers who are placed on a savings path that is unlikely to provide a secure retirement. Late-career employees earn more in retirement benefits for each year of government service than do employees who have worked for 15 or even 20 years in the public sector.

Backloading also creates incentives that encourage workers to stay until they reach a predetermined retirement age—even if it might be preferable for

EXHIBIT 4: MONTANA PROJECTED PERS CONTRIBUTIONS



* Current policy line assumes Montana keeps the current rate until the plan runs out of money

them to change jobs. Such plans also provide a disincentive for experienced employees to work beyond the plan's specified retirement age.

The traditional defined-benefit system is generally inflexible to workers' preferences regarding when they retire or how long they will work. In the traditional system, workers often have no other option than to take their entire benefit beginning at specific ages, limiting their ability to structure their retirement to meet individual needs. Traditional defined-benefit systems can also affect public employers if valuable workers want to continue to serve in the public sector but are forced out.

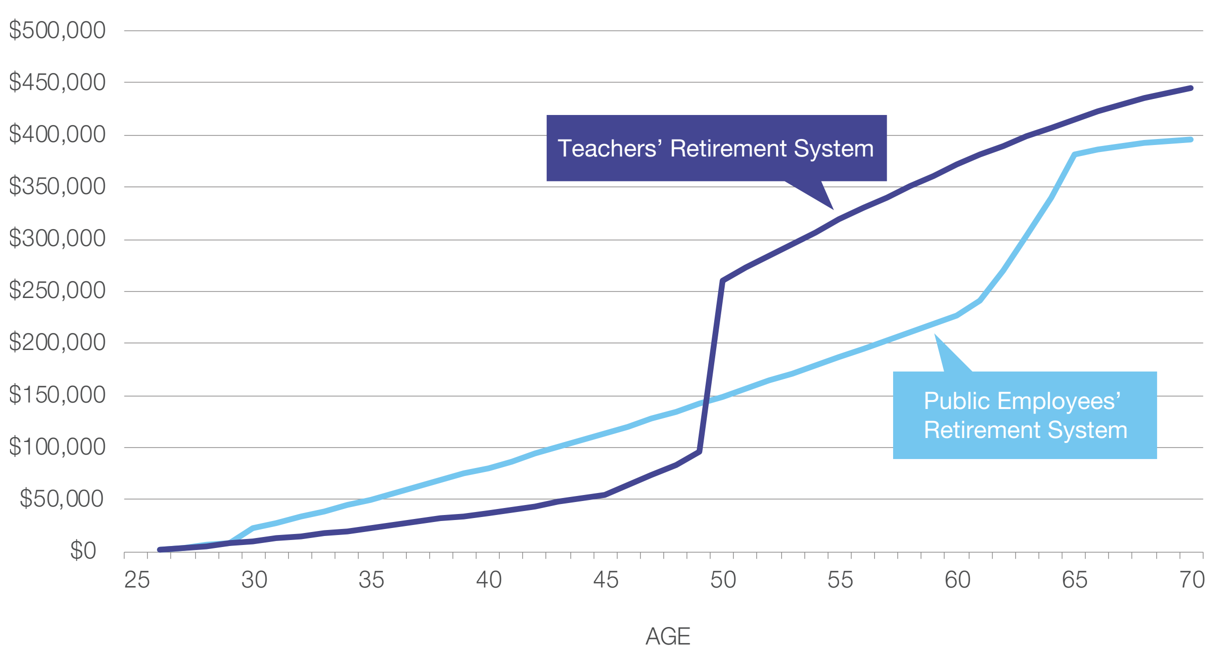
The different benefit structures of PERS and TRS offer a useful contrast in how workers earn benefits in Montana. Workers in PERS get either a pension benefit under the traditional defined-benefit rules or the money purchase benefit, whichever is higher. The money purchase benefit, which is similar to a cash-balance benefit, offers an annuity based on employer and employee contributions and a fixed annual interest rate and offers a better benefit to workers early in their careers. Teachers under TRS, on the other hand, just get a traditional defined benefit plan. The public employees' plan is much more generous than the teachers' plan through the beginning and middle portions of workers' careers. A worker who joins PERS at age 25 and leaves at 42 would receive a benefit worth twice as much as a similar employee in TRS. The opposite is true for late-career employees, where TRS offers a more generous benefit than PERS (See Exhibit 5).

Retirement Benefit Design

As they shape reforms, Montana state leaders should consider the structure of the state's retirement system and ensure that the compensation package offered by the state helps public employers effectively recruit and retain

EXHIBIT 5: COMPARING THE MONTANA PERS PLAN WITH THE TRS PLAN

Value of Earned Retirement Benefits for a 25 Year Old Entering PERS or TRS; Adjusted for Inflation



SOURCE: October Three

a talented public-sector workforce. In doing so, policymakers will need to grapple with two important design questions:

- How will the plan manage and share risk?

- How will benefits accrue and be delivered to workers?

Avoiding risk entirely is impossible. And most public employers will want to take on some amount of investment and longevity risk. Responsibly managing plan risk is an essential element of good retirement plan design.

As previously explained, the state's current plans offer a backloaded benefit, placing early- and mid-career workers on an insecure retirement savings path and creating some potentially undesirable labor market incentives. State policymakers should consider plan structures that allow workers to earn retirement wealth more smoothly across their careers and provide additional flexibility in the timing and structure of their retirements.

While it will be important for policymakers to address the questions raised in this brief, it is equally important to maintain plan features that are good for workers. The state should include as part of any retirement plan:

- an unwavering commitment to full funding. savings and benefit accrual rates that will provide a reasonable benefit for all workers regardless of tenure.

- investment options that have pooled assets that are professionally managed with low fees. easy annuitization at reasonable rates.

These features can and should be included in any retirement plan offered by the state whether it is a traditional defined-benefit, a 401(k)-style defined-contribution plan or another structure such as a stacked-hybrid or cash-balance plan.

A Framework for Reform

Montana's leaders should commit to comprehensive reform that will fix the state's pension problems once and for all. Any changes should honor benefits that already have been earned, as accrued benefits are legally protected. In the end, comprehensive pension reform must accomplish three goals:

1. Develop a plan to responsibly pay down the unfunded liability over a reasonable period. Ideally, the plan should not impinge on funding for key services, hurt the state's overall economic viability, or push the cost too far into the future.

2. Adopt a reformed retirement system that is affordable, sustainable, and secure. The retirement system should ensure a secure retirement for workers and reduce the potential for unforeseen cost increases or missed payments to create future funding crises, threatening public workers and taxpayers. The reformed plan should reasonably guarantee full funding, so the state will not miss a payment even if costs rise.

3. Ensure that whatever plan the state offers enhances its ability to recruit and retain a talented public-sector workforce. Retirement savings are just one piece of total compensation, and policymakers must be thoughtful about how they allocate their limited dollars.

Montana's Pension Reforms Have Fallen Short

In recent sessions, the Montana legislature has worked to improve the pension system's funding situation. The state has enacted multiple one-time general fund appropriations to help address the pension deficit. In a 2005 special legislative session, Montana appropriated $125 million from the general fund to PERS and TRS.

Although one-time cash infusions reduce the overall funding gap of a struggling pension system, the underlying problem of employer contributions that are disconnected from benefit costs remains, and the funding gap can continue to grow. For instance, even though in 2005 and 2007 TRS received a total of $150 million in one-time general fund appropriations, in 2012 the plan was only 59 percent funded. Similarly, despite receiving a $25 million one-time cash infusion in 2005 and 100 percent of the annual recommended contribution from public employers both in 2007 and 2008, PERS' funding ratio decreased from 86 percent in 2005 to only 67 percent in 2012.

Montana lawmakers have also enacted a number of benefit changes for new employees. In 2007, the state cut the guaranteed annual benefit adjustment for new hires from 3 percent to 1.5 percent. By 2011 lawmakers had made several changes that further reduced benefit generosity for new workers. The changes increased employee contribution rates for new members in Montana's main pension plans by 1 percent, raised the minimum retirement age by increasing service requirements, and modified the formula used to calculate retirement benefits. While these changes will reduce pension costs over time, they do nothing to address the existing pension debt. These new plans, while less generous, also continue to promise a risky benefit with hard-to-predict costs. And in the case of TRS, the benefits earned by workers remain highly backloaded.

Current reform proposals to increase contributions fail to address the structural problems of Montana's pension plans

Montana Gov. Steve Bullock has said pensions will be an important issue in the 2013 legislative session. What the state needs is comprehensive reform that will fix all parts of the problem. One set of pension proposals seeks to address the pension deficit through additional employee and employer contributions, and additional payments from the state's natural resources revenues. These are a good starting point and would put much-needed revenue into Montana's pension plans. But without fixing the structural problems that have allowed the pension debt to grow so rapidly, policymakers will have failed to adequately secure worker benefits and set the state's retirement system on a truly sustainable course.

Similarly, switching new workers to a new plan, even a well-designed and affordable one, does nothing to deal with the existing pension debt. Real reform will need to close the state's funding gap over a reasonable period, either by putting new money into the system by raising revenue or cutting spending in other areas. It may be necessary for current employees to be part of the solution. Labor groups in Montana have been vocal about the need for reform and have offered to increase employee contributions.

A comprehensive solution must do more than simply raise contribution rates while keeping them fixed. Such a proposal will not solve the problem of inflexible employer contributions that fail to adjust to the actual cost of benefits. Offering a traditional defined-benefit plan requires the funding discipline to increase employer contributions when circumstances call for it, even if it is painful. The promises Montana has made are risky and can be hard to predict, and in the event that costs rise, employer contributions need to rise with them. Making pension promises without a commitment to pay for them is unfair to current workers and retirees as well as taxpayers.

Comprehensive Reform for Unique Challenges

There is no one-size-fits-all solution. Every state has a unique set of policy preferences, political dynamics, and budgetary challenges. Real change requires good information, thoughtful debate, and ultimately hard choices. Policymakers should pursue real, comprehensive reform that is driven by data and actuarial analysis. Montana needs a fair set of solutions that will offer retirement security to public workers while protecting taxpayers and maintaining the state's ability to deliver important public services.

Endnotes

1. The actuaries for the Montana Public Employee Retirement Association (PERA), which manages seven of the eight Montana pension plans, reported in the latest PERA annual report that four of the seven PERA pension plans, including the Public Employees' Retirement System, were not "actuarially sound" and would not manage to close their existing funding gap at any future point based on current policies. The actuaries for the Montana Teachers' Retirement System reached a similar conclusion in the plans' actuarial valuations and annual reports.

2. Actuarial analysis for this brief was provided by October Three LLC, an actuarial firm based in Chicago.

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