Attachment A

PLEASE SUPPORT HB 1201
A Bill to Align PERA Highest Average Salary With Other States
SPONSORS: Rep. Priola(R) & Sen. Lambert (R)

What does the bill do?

Aligns PERA Highest Average Salary calculation with that of other states. Current law averages the three highest annual salaries of a member of the public employees' retirement association (PERA) when calculating that member's retirement benefit amount. This bill changes the Colorado HAS metric from 3 years to 5 for anyone who will be a new hire (as of December 31, 2014). A number of other states average the 5 highest annual salaries when calculating retirement benefits.

Why is this necessary?

Four primary reasons

1. Even with the reforms of Senate Bill 1, PERA as a percentage of operating expenses for school districts across the state has gone up. Graph 2 on the next page helps illustrate these increased expenses. This legislation will help counteract this trend, allowing school districts across the state more financial flexibility.
2. During the discussion on SB 10-001, PERA recommended that the HAS be raised from three years to five.
3. As of 12/31/12 (number from June 2013 PERA report), PERA had a 61.9% unfunded ratio.[1] While the unfunded ratio has admittedly been higher in the past, the sheer amount of unfunded liabilities has grown dramatically to $24.2 billion, roughly 25% larger than the entire state budget and around 10% of state GDP.[2] Graph 1 in this packet helps illustrate this point. Changing the HAS calculation is a financially responsible step in the right direction in helping the financial solvency of the PERA fund by reducing future liabilities by $277.9 million through 2045.[3]
4. Changing the HAS calculation from three years to five years will help prevent public pension spiking. Many states have been recently changing their public pension funds from calculating the benefits distributed from three years HAS to five years HAS to help create greater equitability within the fund.

Aligning PERA with Other State Pension Plans.

Changing the HAS calculation from three years to five years is a prudent policy that many states have adopted relatively recently (since 2002) to help reign in pension liabilities in a responsible way. These states include Arizona, Florida, Kentucky, Louisiana, Maryland, Montana, Virginia, and Washington. In addition, out of the 41 other states that uses a HAS metric in their state employee pension plans, 26 (or 64%) of such plans have a HAS greater than three years.[4]

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[1] "Colorado Public Employee's Retirement Association: Comprehensive Annual Financial Report," Colorado PERA, December 31, 2012, https://www.copera.org/pdf/5/5-20-12.pdf.

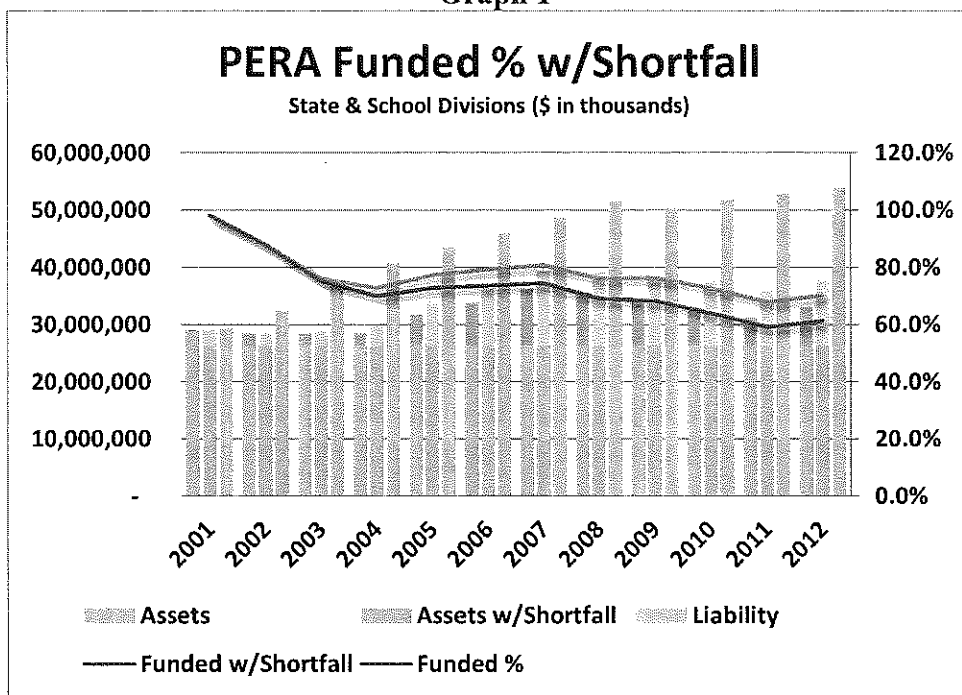
[2] Joshua Smarf, "Pera's Problems in 2013," Independence Institute, http://tax.i2i.org/files/2013/09/IP_6_2013_b.pdf.

[3] See page two of fiscal note.

[4] All data from plan CAFRs or plan website

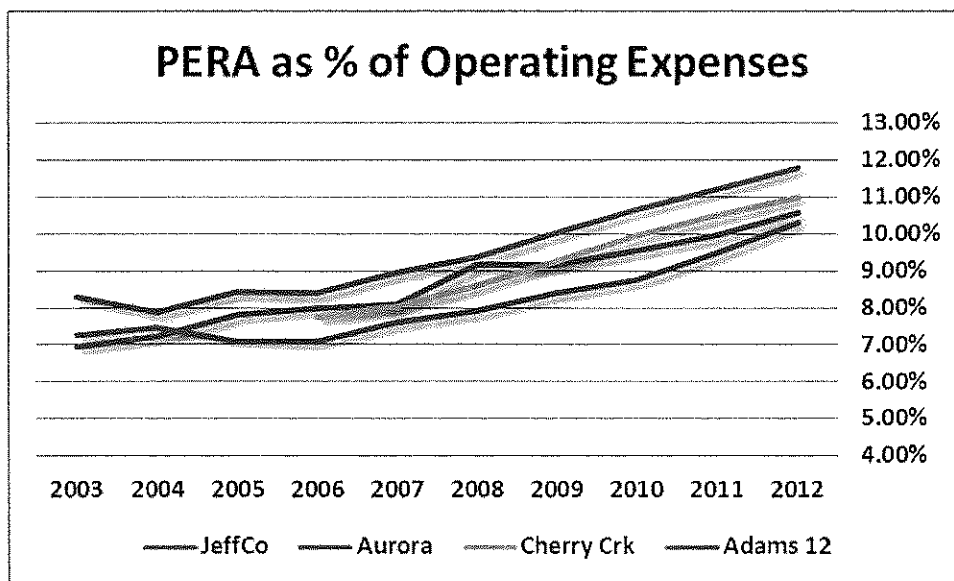
Relevant Graphs

Graph 1



[5]

Graph 2 (Percent of Operating Expenses for School Districts)



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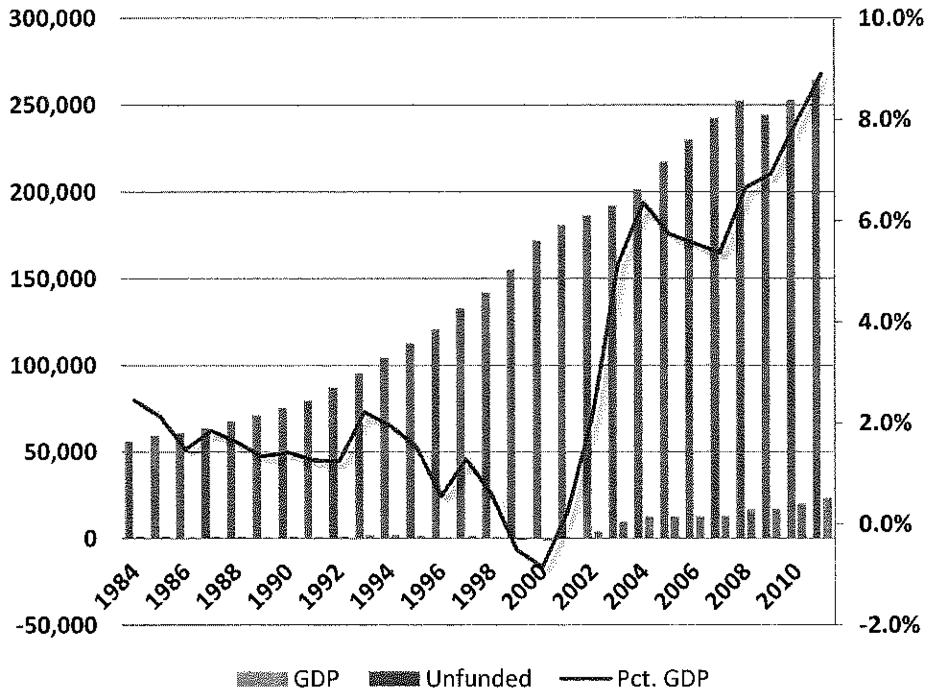
[5] Joshua Smarf, "Pera's Problems in 2013," Independence Institute, http://tax.i2i.org/files/2013/09/IP_6_2013_b.pdf.

[6] Joshua Smarf, "Pera's Problems in 2013," Independence Institute, http://tax.i2i.org/files/2013/09/IP_6_2013_b.pdf.



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7 Joshua Smarf, "Pera's Problems in 2013," Independence Institute, http://tax.i2i.org/files/2013/09/IP_6_2013_b.pdf.

How do we pay for $1 trillion in unfunded public pension liabilities?
By Heather Draper
2/24/14

According to public pension plans' own estimates, the total amount of unfunded public pension liabilities in the United States is nearly $1 trillion.

And you have to look no further than Denver Public Schools to see what happens when a plan chronically underfunds its pension. Denver taxpayers are on the hook for nearly $2 billion (estimated) over the next 25 years for bonds issued to pay off the district's past unfunded pension liabilities.

So how do we pay for all these unfunded public pension liabilities, without putting the burden squarely on future taxpayers?

A panel commissioned by the Society of Actuaries issued a report Monday that provides recommendations to help pension plans improve their financial strength and meet their contractual obligations to their plan members.

The Blue Ribbon Panel on Public Pension Plan Funding laid out three main principles to strengthen public pensions:

- The costs of future retirement benefits should be pre-funded, and funded in a way that targets 100 percent funding of plan obligations. Median economic assumptions should be used to avoid being overly optimistic or overly pessimistic.
- Taxpayers receiving the benefit of today's public employees' services should pay the taxpayer portion of the costs of those employees' pension benefits; funding programs should restrain the tendency to shift these costs to future generations of taxpayers.
- While the panel believes that stable costs will be difficult to achieve, it does recognize the benefits that predictable costs can bring to the sponsor's budgeting processes over short periods of time.

Members of the panel represented a variety of disciplines and interest groups so that the panel examined the issue from multiple perspectives. It began work in early 2013 and issued its final recommendations Monday at an event at the National Press Club in Washington, D.C.

"Taken as a whole, the panel's recommendations will make available to all stakeholders in public pension systems — employees and retirees, plan sponsors and trustees, as well as taxpayers — more reliable and improved information about the financial status of a plan and the risks it faces," said Bob Stein, chairman of the panel and former global managing partner of actuarial services at Ernst & Young.

"This should enable the development of a stronger funding program, more responsive to the rapidly changing environment in which all plans operate," he added.

The panel also provided specific recommendations on better disclosure to all stakeholders about the financial condition and level of risk taken by an individual plan:

- Plan maturity, such as the ratio of active employees to retirees and the ratio of the market-value assets to payroll;
- Plan cost, such as the ratio of the actuarially required contribution (ARC) to payroll and to the funding entities' total budget;
- Payment experience, the ratio of contributions paid to the recommended contribution;

- Investment risk, such as the plan liability at a risk-free rate; and
- Stress tests, consisting of projections of contributions and funded status under periods of higher or lower investment return, and in which recommended contributions were not fully paid.

"The panel has sought to encourage a higher level of financial management and more rigorous risk analysis among public pension plans," Stein said. "That focus is manifested in the comprehensive disclosures recommended, which should enable all parties involved to make more fully informed decisions about plan funding."

The panel also recommended creating a standardized contribution benchmark, strengthening the role of actuaries in the plan funding decisions and improving plan governance, including strong oversight by plan boards.

Source: Denver Business Journal[8]

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[8] http://www.bizjournals.com/denver/blog/finance_etc/2014/02/how-do-we-pay-for-1-trillion-in.html

PERA bailout shortchanges students, teachers
By Mark Hillman
March, 29, 2013

As Colorado lawmakers consider an overhaul of the way the state funds K-12 education, more people are noticing that schools are increasingly forced to pay for the past rather than invest in the future.

Our public schools must take money out of the classroom in order to pay for investment losses and unaffordable promises that have created a $25 billion shortfall in the Public Employees Retirement Association (PERA).

In August 2012, Adams 12 School District teachers protested a 2 percent salary reduction enacted explicitly to offset the rising cost of PERA's bailout plan. For 2012-13, Adams 12 will pay $190 million in salaries, plus $36 million for PERA and Medicaid.

In 2010-11, Colorado Springs School District 11 paid $21 million to PERA, according to the Colorado Springs Independent. Those payments, combined with funding reductions by the state legislature, led the district to close schools and make cuts that affected everything from textbooks to class size to suspending pay increases.

District 11 chief financial officer Glenn Gustafson told the Independent: "To improve student achievement, it's more important than ever to attract qualified and talented teachers. But we're shifting a disproportionate amount of compensation to retirement benefits and health care."

For 2011-12, my hometown Burlington School District RE-6J, with just 738 pupils, faced a $300,000 budget deficit — half of that amount caused by the cost of PERA's bailout. For 2012-13, the district decreased salaries by $54,399, but the mandatory PERA contribution increased by $38,594.

Many rank-and-file PERA members simply want a reliable retirement. However, lobbying groups and lawsuits purporting to represent PERA members are obviously more concerned with preserving current benefits than the finances of younger workers now and at retirement.

Responsibility for ensuring a sustainable benefit structure rests with the PERA Board of Trustees and, ultimately, with state legislators and the governor. To continue to promise benefits that are unaffordable and unsustainable is simply unconscionable.

In 2013, the cost of the PERA bailout — not including standard employee and employer contributions — in just the School Division is an estimated $244 million, or $299 for each of the 817,221 students funded by the School Finance Act. In a classroom off 20, that's nearly $6,000 that cannot be spent to make students smarter or pay good teachers better.

This cost will increase by another 56 percent by 2018 — to an estimated $9,340 per classroom — and continue for at least 35 years, when today's first-graders will have children who are old enough to drive.

Do PERA pensioners really believe that keeping every last cent of their benefits is worth taking nearly $10,000 away from their grandchildren's classrooms?

Parents must wonder: What can possibly justify penalizing two full generations of students for a mess created long before their lives began?

For young teachers, the PERA bailout plan leads to a vicious cycle. A teacher who starts work today will soon see his or her wages and benefits suppressed by 10 percent per year to pay for the bailout. Adding insult to injury, lower salaries result in lower retirement benefits.

School boards, too, are caught in a vice because some 80 percent of their district budgets pay for salaries and benefits. No other line item is large enough to produce the savings necessary to pay for the tremendous cost of the PERA bailout.

Likewise, the PERA bailout is crowding other priorities out of the state budget. When fully implemented in 2018, it will cost more than the general fund expenditure for any department except for the four largest — Education, Corrections, Health Care Policy and Financing, and Human Services, based on the most current data available.

If we truly value our future, then we really should ask if it's wise to shortchange schools for the next 35 years in order to pay for past mistakes.

Source: Denver Post[9]

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[9] Mark Hillman, "PERA Bailout Shortchanges Students, Teachers," *Denver Post*, February 28, 2013, http://www.denverpost.com/ci_22893614/pera-bailout-shortchanges-students-teachers.

PERA may be most troubled pension in the country
By Dr. Barry Paulson
July 15, 2011

In a July 3 Denver Post article, "PERA paints a rosy future", Colorado Senate President Brandon Shaffer is quoted as saying, "We fixed our state pension system." Nothing could be further from thef truth. Recent research reveals that Colorado's Public Employee Retirement Association (PERA) is the most underfunded pension plan in the nation, even after the reforms enacted in 2010 in Senate Bill 1.

PERA discounts the liabilities in the pension plan at 8 percent, the rate of return it assumes on investments. Most financial experts argue that pension plans should use a rate of discount that reflects the market risk inherent in those liabilities. For example, a recent study by finance professors Robert Novy-Marx and Joshua D. Rauh, "The Revenue Demands of Public Employee Pension Promises," uses actual Treasury yields to calculate the present value of liabilities in state and local pension pans.

They then calculate the contributions that state and local governments would have to make to pay off these liabilities over a 30-year period.

To pay off liabilities in the pension plan over a 30-year period, annual contributions to PERA would have to more than quadruple from the current 11.3 percent of payroll to 53.9 percent of payroll.

There is no other pension plan in the country that imposes such a financial burden on future taxpayers. Every household in Colorado would have to pay $1,739 more in taxes annually, just to meet pension obligations.

It should be emphasized that these estimates reflect the reduction in cost-of-living adjustments enacted in Senate Bill 1, and recently upheld in Denver District Court.

If more than half of every salary dollar must be earmarked to pay off liabilities in the pension system, this would not leave much revenue for government services. Fully funding the PERA pension plan would require more layoffs of teachers, firefighters, police and other public sector workers. In recent years 10 states have replaced their defined benefit plan with a defined contribution plan. In a "soft freeze" the defined benefit plan is closed to new employees who are then required to enroll in a defined contribution plan, or a hybrid plan combining defined contributions and defined benefits. In their analysis, Novy-Marx and Rauh estimate that in most states a "soft freeze" has moderate revenue saving effects. However, in seven states, including Colorado, a soft freeze increases the fiscal burden of the pension plan on the state. That is because in these states the government must bear the cost of the defined contribution plan plus the entire Social Security contribution.

In states such as Colorado only a hard freeze will generate revenue savings in the pension plan. In a hard freeze all employees, including current employees, are required to enroll in a defined contribution plan; all future benefits in the defined benefit plan are terminated. The benefits already earned by current employees and retirees in the defined benefit plan are fully funded, and Social Security benefits are extended to all employees.

In Colorado such a hard freeze would reduce the required increase in PERA contributions from 42.5 to 32.6 percent of payroll.

Even with this reform, significant increases in taxes or reductions in government services would be required to fully fund the pension plan, but the financial burden would be much less than that required by the current defined benefit plan.

Most private employers have in fact implemented either a soft freeze or hard freeze to constrain the cost of their private pension plans. Novy-Marx and Rauh maintain that there is a high probability that defined benefit plans with significant unfunded liabilities, such as PERA, will default on their obligations. The risk of bankruptcy is what has led Utah and other states to enact a soft freeze, replacing their defined benefit pension plans with defined contribution plans.

It would be more difficult and costly for Colorado to enact such a reform because of the magnitude of unfunded liabilities that have already been incurred in PERA; but that is all the more reason to enact reforms now, rather than wait for the funding crisis in PERA to bankrupt the state.

Source: The Gazette[10]

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[10] Barry Poulson, "Pera May Be Most Troubled Pension in the Country," Gazette, http://gazette.com/guest-column-pera-may-be-most-troubled-pension-in-the-country/article/121630.

Reports: 21 States' Pension Systems Not Fiscally Sound
By Mike Maciag
November, 29, 2012

State pension systems suffered a significant blow during the recession, but it didn't hit all systems equally; some fared much worse than others.

A study by investment research firm Morningstar, Inc., published earlier this week assesses the financial health of each state system, highlighting a wide disparity in the actuarial adequacy of funding levels.

An alarming number of funds face a steep uphill climb in fully funding their plans. The report found 21 states' aggregate funded ratios fell below 70 percent, which Morningstar considers the threshold for "fiscally sound" systems. Illinois (43.4 percent), Kentucky (50.5 percent) and Connecticut (53.4 percent) registered the lowest funding levels of all examined.

The common industry standard for a "healthy" system is that it's 80 percent funded when looking at obligations to retirees, although the number is the subject of debate.

Morningstar also appraised states' fiscal health by calculating the unfunded actuarial accrued liability per capita, approximating the amount for which taxpayers would be on the hook if each had to ante up to make the systems whole. By this measure, Alaska tops all other states with an unfunded liability of $10,235 per resident for its plans, followed by Illinois and Hawaii.

Other states have managed to largely shore up their funds. Eight states recorded unfunded liabilities of less than $1,000 per capita, while seven systems' aggregate funding ratios exceeded 90 percent. The report lauded Wisconsin – with a 99.8 percent funded ratio for its system -- as the nation's strongest.

While declines have slowed in recent years, the figures dating back to 2007 still signal a downward slope for most systems' funding levels. Much of this has to do with "smoothing," an accounting practice that considers deviation between actual and expected returns over several years, essentially spreading out pension gains or losses over longer periods. Since most assume a five-year smoothing period, many funds have not yet fully absorbed investment losses to their portfolios incurred during the recession.

Rachel Barkley, a Morningstar municipal credit analyst who authored the report, cited the financial health of Illinois' pension system as particularly poor. Updated data released by the state last week indicates the situation has worsened, with the aggregate funded ratio further dropping from 43 to 39 percent. The culprit in Illinois has largely been due to the failure of the state to make the necessary contributions to the pension fund to maintain its actuarial integrity compounded by less than stellar returns, she said.

"It's been chronically stressed with poor management decisions," Barkley told *Governing*.

Illinois' investment returns failed to meet assumptions, while contributions from the state and local governments ended up below the annual required contribution. The state legislature passed reforms aimed at replenishing the system in 2011, but failed to approve additional measures during a special session this fall.

Some separate retirement funds within single states are also in far worse shape than others, but this disparity is hidden because the report uses aggregate totals for all public employee systems. Minnesota's various retirement plans for rank and file and other covered employees were collectively 79.3 percent funded, for example, but its Legislators Retirement Plan was actually less than 9 percent funded.

Pension plans for teachers and education employees, which account for about half the public workforce, make up a sizable portion of states' liability. Not all states, though, contribute to teachers' pension plans. Colorado, one such state, recorded an unfunded liability per capita of $1,804 – below most others, which might give the impression that the fund is relatively healthy. But it isn't. The system's funded ratio was 57.7 percent, far worse than most states.

It's for this reason that Barkley suggests weighing the health of pensions both by actuarial calculations and by the per capita method when assessing the overall health of a pension system.

While Morningstar set a 70 percent threshold for fiscally sound systems, and other credit rating agencies peg it at 80 percent, the American Academy of Actuaries went a step further earlier this year, calling the 80 percent funded ratio a "myth." Plans should aim for accumulating assets of 100 percent of pension obligations, the association said in an issue brief.

Keith Brainard, research director for the National Association of State Retirement Administrators, said the report accurately depicted the dynamics of state pension systems. He emphasized, though, direct comparisons between state plans' financial health can be deceptive.

"Public pension plans are nuanced and distinctive creatures of state government," he said. "Sweeping statements and broad generalities about the public pension community are usually misleading at best."

The Morningstar report also cautions against direct comparisons. Benefit types vary, and multiple public entities are often responsible for contributions and liabilities associated with plans.

What's more, plan management strategies and assumptions differ. Most plans assume an investment return rate of 7 to 8 percent. The Indiana Public Retirement System, though, recently adopted an assumed return rate of 6.75 percent – the nation's most conservative rate, according to the state.

Source: Governing.com[11]

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[11] Mike Maciag, "Report: 21 States' Pension Systems Not Fiscally Sound," Governing, November 29, 2012, , http://www.governing.com/blogs/by-the-numbers/state-pension-systems-funded-ratios-financial-health.html.