ADJUSTING Public Pension Benefits in Colorado

A FIDUCIARY PROCESS

BY GREGORY W. SMITH

From late 2007 into 2009, the United States and countries around the world experienced the worst financial collapse since the Great Depression. The U.S. economy was officially in a recession for 18 months from December 2007 until June 2009. The Dow Jones Industrial average sank from 14,279 in October 2007 to 8,776 on December 31, 2008 (a 39 percent decrease), and bottomed out at 6,440 in March 2009 (a 55 percent decrease). The severe market downturn in 2008 caused substantial investment losses for all investors around the world, including the Colorado Public Employees' Retirement Association (PERA), which administers a defined benefit (DB) plan in which all teachers, K-12 staff, state employees, state court judges, and employees of 143 local government units in Colorado participate. While faring better than many of its peers and the market indexes, PERA's assets decreased by 26.2 percent, amounting to approximately $11 billion in investment losses, with assets falling from approximately $41 billion to approximately $30 billion.

For the first time in its history of more than 75 years, PERA's long-term viability was imperiled. The pension system could no longer guarantee that its members would receive a benefit for their lifetime. In fact, PERA's financial projections indicated that the trust funds would be exhausted within 30 years. This reality was a call to action for the PERA Board of Trustees, and the question became, what is the proper fiduciary response to such a crisis? This article will focus on the process undertaken by the PERA Board of Trustees in response to the economic crisis of 2008, a process that ultimately resulted in the country's first reduction in a fixed, statutory cost-of-living adjustment (COLA), applicable to existing retirees.

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GETTING THE NUMBERS RIGHT

Across the country there are many governance structures for public DB plans, but the feature common to all of them is the existence of a plan fiduciary. In the case of Colorado PERA, a statutorily created board of trustees serves as the fiduciary responsible for overseeing the investment program and benefit administration, while the Colorado General Assembly (with approval of the governor) is responsible for setting the benefit formula as well as the contribution rates for both employers and employees. In the last days of the 2009 Legislative session, the General Assembly charged the PERA Board of Trustees with making a comprehensive recommendation by November 1, 2009, to return the DB plan to long-term sustainability, with all unfunded liabilities paid off within 30 years.

The board's first step in developing a comprehensive response to PERA's funding crisis was to ensure that the numbers were right. To that end, the board undertook several studies to ensure that it knew exactly what the impact of 2008 was on the system. The process began with an independent financial audit to verify the 2008 investment results and market value of all DB plan assets. Next, the board retained an independent national actuarial firm to conduct the annual actuarial valuation. (The actuarial valuation determines the funded ratio of the plan — assets versus net present value of accrued benefits — and the amount of employer and employee contributions necessary to bring the plan to 100 percent funding within 30 years — referred to as the actuarially required contribution, or ARC).

To accurately determine the funded ratio and ARC, the actuaries must use assumptions regarding important future events, such as how long members will live on average, how much salaries will increase, how long members will work before retiring, and many others. To determine whether the assumptions are supported by the actual experience of the plan in recent years, PERA's actuaries conducted an actuarial experience study, analyzing every assumption used and making recommendations regarding modifications. Realizing the critical importance of working with accurate numbers, the PERA board then contracted with a separate independent national actuarial firm to repeat all the work of PERA's original actuaries and audit their conclusions. The experience study and actuarial audit resulted in modest adjustments to a few assumptions.

The most important assumption for purposes of analyzing PERA's future is arguably the assumed investment rate of return, which establishes the average annual growth rate of the assets managed by PERA. Setting the investment assumption rate requires a rigorous process using qualified and independent experts reporting directly to the board. In 2009, after the significant downturn in the market, and after hearing from its actuary, its auditing actuary, and its investment

consultant, PERA's board voted to move from an 8.5 percent to an 8 percent assumed rate of return. The 8 percent rate of return was used in developing PERA's comprehensive legislative recommendation.

DEFINING THE GAP

After ensuring the actuaries had the numbers right, the PERA board took the next step: defining the funding gap. To do so, PERA's actuaries did actuarial projections of the funded status of the system into the future. These actuarial projections simulate future actuarial valuation results over a forecast period to determine exactly where PERA's funded ratio would stand in each of the next 30 years.

Applying the new assumed rate of return and all the other verified actuarial assumptions, the comprehensive analysis by independent actuaries came to the conclusion that without changes, the PERA pension system would run out of money in less than 30 years. The projection results made it clear that PERA had to make the difficult choice of proposing significant changes to the system in order to ensure that the system would be sustainable in perpetuity. The question became, what would those changes be, and to whom would they apply? To begin to answer this question, the board analyzed the impact of changing each component of the benefit formula. They analyzed benefit changes to future hires, new hires, non-vested actives, non-vested inactives, vested inactives, vested actives, and existing benefit recipients. The mantra was "nothing is off the table; everything is being considered and priced."

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DEVELOPING THE SOLUTION

The fiduciary duty of the PERA Board of Trustees, as in all DB plans, extends to each member of the fund, regardless of whether the individual is retired or has been contributing to the fund for 20 years, 10 years, or one year. The board has the same fiduciary duty to the retiree who has been retired for 20 years as it does to the member hired yesterday who contributes 8 percent of his or her salary, expecting to receive a retirement benefit in the future. The information available to the PERA board indicated that PERA would be taking contributions from new members while knowing that the fund would run out of money before any benefits could be paid to those members.

As PERA began exploring possible solutions to the funding issues, transparency became the foundation on which the solution was built. It began with a "listening tour" consisting of eight meetings held across the entire State of Colorado, where members of the PERA board and the executive team reviewed the nature and extent of the funding crisis with members, retirees, the media, and the public. People who attended the meetings were invited to address the board and executives regarding their thoughts on the possible solutions. A comprehensive list of possible changes was handed out at each meeting, and attendees were asked to mark their support for each possibility and provide narrative comments regarding their own ideas. In addition, a video of the listening tour presentation was posted on the PERA Web site, along with an electronic version of the survey. More than 4,000 survey responses and 2,000 narrative comments were compiled and provided to the board for consideration. The listening tour allowed PERA to convey the critical nature of the funding problem and to engage members, retirees, and the public in searching for possible solutions.

After the listening tour, the PERA Board of Trustees met and developed guiding principles for developing the comprehensive solution to PERA's funding crisis. In a formal motion, the board voted that the following principles would guide this process:

- Shared responsibility among members, retirees, and employers
- Intergenerational equity
- Long-term sustainability
- Preserving the defined benefit plan
- Maintaining the same benefit structure for PERA's divisions.

The board identified two other important goals: 1) the proposed changes should be designed to have little or no short-term impact on member behavior, and 2) the proposal should aim to amortize the unfunded liability over a 30-year period, which was consistent with state law and with the standard set forth by the Governmental Accounting Standards Board (GASB).

After setting its goals, the PERA board began analyzing every facet of the pension system. The financial requirements of a DB plan can be depicted by a simple formula: contributions + investment income = benefits + expenses. There are only four variables, and eliminating the funding gap requires either increasing revenue through contributions or investment income or reducing costs by lowering expenses or cutting benefits.

Solving the funding gap by increasing contributions from the employers was considered at meetings with employee and employer groups, retiree groups, legislators, and many others. With the State of Colorado facing a multi-billion dollar budget crisis, the meetings led to a general consensus that it was simply not possible to increase contributions by more than 2 percent for employers over a period of years, and the same for employees. To eliminate the gap through contributions would have required an immediate increase of contributions by 21 percent of salary, on top of the existing contributions.

After contributions, PERA looked at the investment program. Sensitivity testing demonstrated that even if the system's investments returned 10 percent per year for 30 years, PERA would still run out of money. Generating a greater return on investments requires taking greater risk, and the PERA board did not believe that increasing the risk profile of the program was prudent or appropriate. The answer was clear; it was not possible to invest out of the funding gap.

With regard to the expense part of the equation, a decrease in expenses would not have a measurable impact on PERA's funded status. PERA already has very low operating expenses and uses approximately four-tenths of 1 percent of its assets to pay plan expenses, including investment costs. Operating efficiencies could not meaningfully affect the funding gap.

Consistent with the guiding principles established by the board, as described above, PERA analyzed a myriad of possible benefit changes and combinations of changes. When PERA's actuaries modeled these changes, one thing became clear: without reducing the fixed 3.5 percent COLA for existing retirees, there was nothing that could be done to solve the problem, and PERA would run out of money before it would see sufficient savings from other benefit changes to make a difference. Every viable solution PERA's actuaries delivered to the board included a reduction in the COLA paid to existing retirees.

After the initial projections, the board commissioned projection software specific to the PERA benefit structure. The software would allow the board to assess not only the impact of a single benefit or contribution change on PERA's future funding status, but also the combined effect of multiple changes simultaneously on PERA's future. This tool was critical in identifying the components necessary for a successful recommendation and in demonstrating the appropriateness of the suggested changes. Employer and employee groups as well as state legislators in one-on-one and group meetings were given access to the projection software to examine "what if" scenarios. Once again, transparency supported the board's recommended course of action.

Based on its extensive analysis, PERA developed its recommended legislative package, termed "2/2/2 Plus," which addressed the funding issues in an equitable manner and met the board's guiding principles. The recommended package had three major components: 1) reduce the 3.5 percent COLA to 2 percent for all current and future retirees; 2) increase employer contributions by 2 percent; and 3) increase contributions funded by employees (through foregone salary increases) by 2 percent. These additional contributions were to be implemented gradually, over a period of years. In addition to these major components, the package had additional changes to the benefit structure for all retirees, active members, inactive members, and future hires. (To see

the entire 2/2/2 Plus proposal, visit PERA's Web site at http://www.copera.org/pera/legislation/sb10001.htm.)

DISCLOSING THE SOLUTION

Fulfilling its statutory mandate, on October 30, 2009, PERA submitted to the General Assembly its proposal to reach fully funded status in 30 years. Afterward, PERA held an additional 13 meetings across the state to explain the proposal. At these "shareholder" meetings, PERA distributed ballots asking if attendees supported or opposed the 2/2/2 Plus proposal. Of the 1,174 votes cast, 83.5 percent supported the proposal. PERA continued to stress the magnitude of the problem and engage in complete transparency.

The 2/2/2 Plus Plan largely became SB 10-001, which was introduced on the first day of the 2010 legislative session. The support by employee and retiree organizations was unanimous. Ultimately, the bill was passed with bipartisan support in both the Senate and House of Representatives, and was signed into law on February 23, 2010.

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LEGAL CONSIDERATIONS

The PERA board analyzed the legal framework for modifying benefits, in addition to the many other relevant considerations. Under the contract clause of the federal and most state constitutions, benefits can be modified only in certain circumstances. There is a multi-pronged test for determining the constitutionality of statutory changes to a contract. First, it must be determined whether there is a contract, and if so, its terms. Next, it must be determined whether the modifications would substantially impair the contract, and if so, whether the impairment is reasonable and necessary to serve an important public purpose. When determining whether there is a substantial impairment, one must examine the legitimate and reasonable expectations of the parties. After that, the analysis moves to whether the changes were reasonable and necessary. Necessity is judged on two levels: 1) whether a less drastic modification could have been implemented; and 2) whether, even with modification, the state could have achieved its stated goals. To determine whether the changes were reasonable, the changes must be the minimum changes necessary to solve the economic problems of the plan. (See *United States Trust Co. v. New Jersey*, 431 U.S. 1, 1977.)

In 2002, the Colorado Supreme Court set forth the modern test for determining whether a challenged statute is constitutional under Colorado and U.S. contract clauses. In *re Estate of DeWitt*, 54 P.3d 849, 853 (Colo. 2002), the court ruled that "a court should uphold a challenged statute if it is reasonable and appropriately serves a significant and legitimate public purpose when considered against the severity of the contractual impairment." In *DeWitt*, the Colorado Supreme Court extensively cited and followed U.S. Supreme Court precedent. As stressed by the Colorado Supreme Court in *DeWitt*, the contract clauses of the Colorado Constitution and the U.S. Constitution, "while designed to protect vested contract rights from legislative invasion, are not to be interpreted as absolute."

Within days of passage, the constitutionality of SB 10-001 was challenged in Denver District Court. It is anticipated that the challenge will ultimately proceed to the Colorado Supreme Court for resolution.

CONCLUSIONS

The process PERA went through in making the difficult decision to reduce benefits for its entire membership was very complex. The hallmark of this process was transparency, and every action was guided by the board's duty as fiduciaries to the entire membership. There is no higher duty than that of a fiduciary, and there are instances when being a fiduciary to all of the membership requires that difficult decisions be made to ensure all members receive benefits in the future. The decision by PERA's board, and ultimately the General Assembly, provided PERA a new beginning. This year, when PERA released its 2009 comprehensive annual financial report, which recognized the changes made by SB 10-001, it showed that PERA has attained the 30-year amortization goal and will reach 100 percent funding by 2040. Shared sacrifice was imperative for the future of the fund and through that sacrifice, more than 470,000 PERA members and retirees have regained a sustainable DB plan.

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