

Review and Comparison of the “Utah Model”

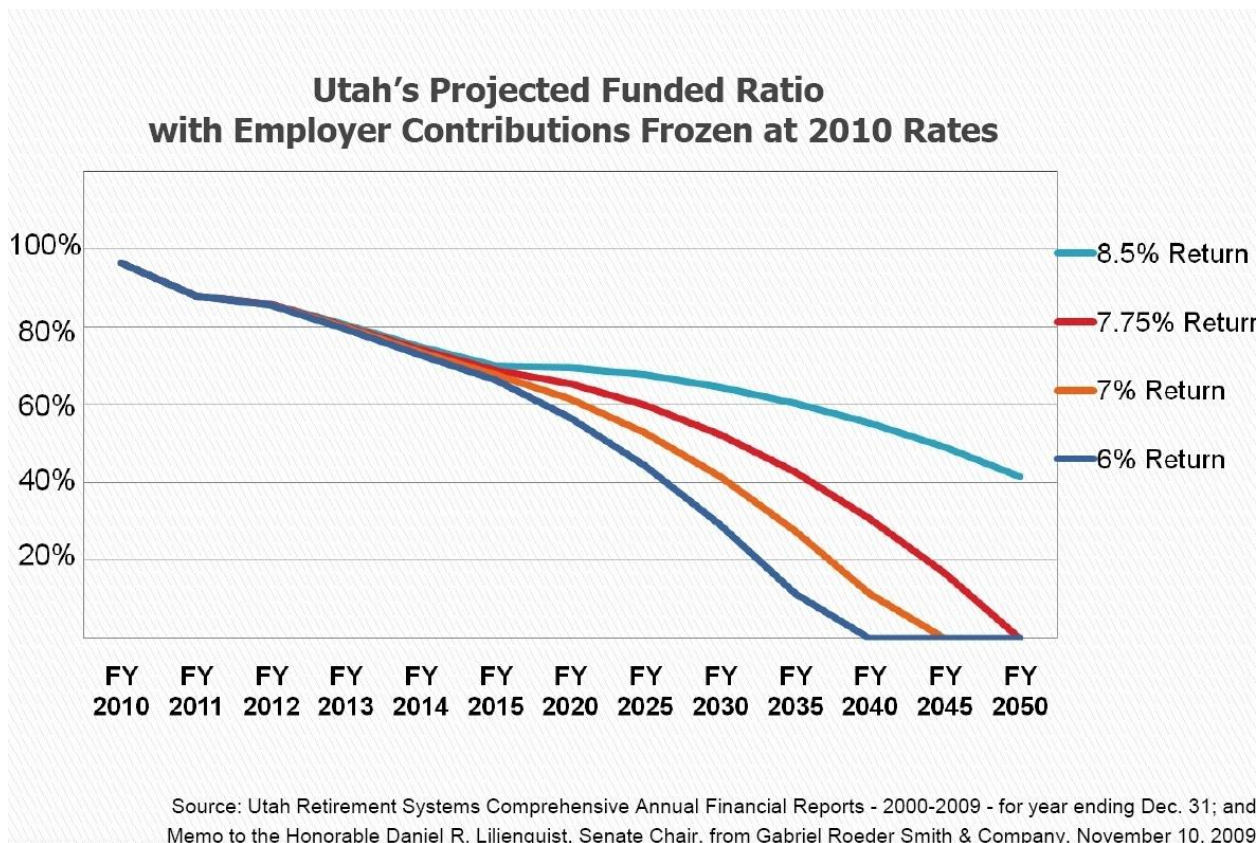
Introduction

In 2010, the Utah Legislature passed Senate Bill 63 creating a two-tiered retirement system for Utah’s public employees. Employees hired before July 1, 2011 are Tier I participants and those hired after that date will be Tier II participants. Effective July 2011, the old defined benefit (DB) plan will be closed to new members.

Tier II participants will have a choice between two retirement plans administered by Utah Retirement Systems (URS). One choice is a straight defined contribution (DC) plan, and the other choice is a plan comprising both DB and DC components. The new legislation sets the employer contribution rate for both plans at 10% of pay for most public employees. (The rate is 12% for public safety employees.)

Reasons for Change

Following the 2008 market collapse, the Utah legislature directed its actuaries to prepare 40-year funding projections for various market returns and contribution strategies. The baseline projection used the fund’s assumed net rate of return of 7.75% and assumed contribution rates would be maintained at actuarially determined levels. In this scenario, contribution rates increased from 13.21% in FY 2010 to 23.1% in FY 2016, and the unfunded actuarial accrued liability (UAAL) climbed above \$6 billion. When the funding status was projected with contribution rates frozen, the fund ran out of money in 30 to 40 years. Since neither of these scenarios was acceptable, it was apparent a change was needed.



Source: NCSL Presentation by Senator Liljenquist

Effects of SB 63

For employees choosing to participate in the hybrid plan, employers contribute the normal cost (currently 8% of pay) into the DB plan. When the normal cost is *less than* 10%, an additional contribution (currently 2%) goes into the DC plan for the employee. If the normal cost *exceeds* 10%, employees must make up the difference to fund the DB plan. The vesting period for the hybrid plan is 4 years.

The pension benefit for the hybrid option is lower than the benefit for the Tier I plan. Pension allowances are determined by multiplying years of service by average salary and a multiplier. The benefit multiplier is 2% for Tier I participants, but only 1.5% for Tier II. The Tier II benefit is also lowered by using average salary over the highest 5-year period, while Tier I uses the highest 3-year period. Normally, average salary gets smaller when the time period is lengthened.

If a new hire elects to participate in the DC plan instead of the hybrid plan, the employer contributes 10% of pay into a 401(k) account for the employee. The vesting period for the DC plan is also 4 years.

The maximum cost-of-living-adjustment (COLA) for Tier II retirees will be lower than the maximum for Tier I. Current retirees receive an automatic COLA of CPI (up to 4% per year). Tier II employees who retire under the hybrid plan will receive annual COLAs of no more than 2.5%.

	Idaho	Utah Tier I	Utah Tier II
Employee Contribution Rate	6.23%	0%	0%
Employer Contribution Rate	10.39%	15.72%*	10%**
Vesting Period	60 months	48 months	48 months
Service Retirement Eligibility	65 or Rule of 90	65 or 30 years svc	35 years svc
-Public Safety Personnel	60 or Rule of 80	60 or 25 years svc	25 years svc
Average Salary Base Period	42 months	36 months	60 months
Benefit Multiplier	2%	2%	1.5%
Statutory COLA	Lower of CPI-U or 1%	Lower of CPI or 4%	Lower of CPI of 2.5%
-Statutory + Discretionary	Match CPI-U up to 6%	n/a	n/a
Average Monthly Benefit	\$1,304	\$1,471	TBD

*Under the old plan, employers contributed 14.22% into the DB plan (13.21% for retirement plus 1.01% for death and other benefits). Another 1.5% goes to the DC plan, for a total contribution of 15.72%.

**The Tier II fixed contribution rate lowers employer costs for new employees, but URS must still amortize its UAAL for the old plan, estimated to be \$7 billion as of December 2010. To help with this, employers will pay an additional percentage (currently 4%) for Tier II employees until the UAAL is eliminated. Thus, total employer contributions for Tier II will be 14% for a period projected to be 25 to 30 years.

Comparing URS and PERSI

URS is considered a private organization and as such is not covered by the Freedom of Information Act. We were not able to obtain a copy of their actuarial report for 2009, so a more thorough comparison was not possible. The information used in this comparison was obtained from the URS Annual Report, various legislative reports and NCSL presentations made by Senator Daniel Liljenquist.

The unenviable situation in Utah is not entirely a result of market performance or bad fortune. The design of the old retirement plan disregarded some basic aspects of a sound plan design. When the Idaho Legislature created PERSI, it designed the plan to better withstand the ups and downs of investment markets.

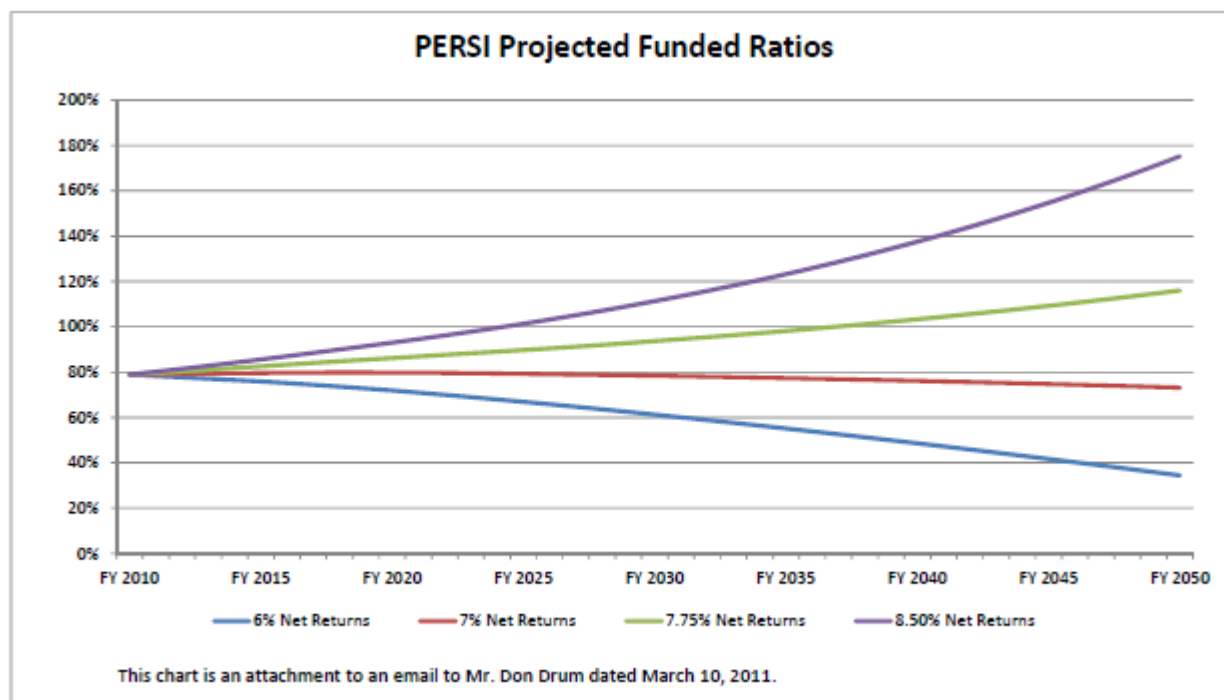
Contributions

One of the most important differences between URS and PERSI has to do with contributions. Idaho employees have always shared in paying contributions to their retirement. While the two systems provide similar retirement benefits, Utah placed the entire contributions burden on the employer while Idaho divided it between employers and employees. Employers pay 5% of the required contributions and employees pay 3% (currently 10.39% and 6.23% respectively).

Funding Projection

As shown on page 1 of this report, Utah's actuaries projected it would go bankrupt if the fund received actuarially assumed returns (7.75%) for the next 40 years.

PERSI engaged its actuaries to prepare a similar set of projections for its funded ratio to FY 2050 with contribution rates fixed at 2010 levels. The resulting graph significantly differs from the Utah graph. In this graph, the green line represents the rate of return (7.75% net) used in PERSI's economic assumptions. The upper purple line closely represents what can be expected if PERSI's average return for the next 40 years is 8.5%, which is equivalent to the actual return average for the past 20 years.



The funded ratio projections clearly show Utah faces serious problems that necessitate change, while PERSI is well positioned to fully recover without changing the plan design or benefit structure.

COLA

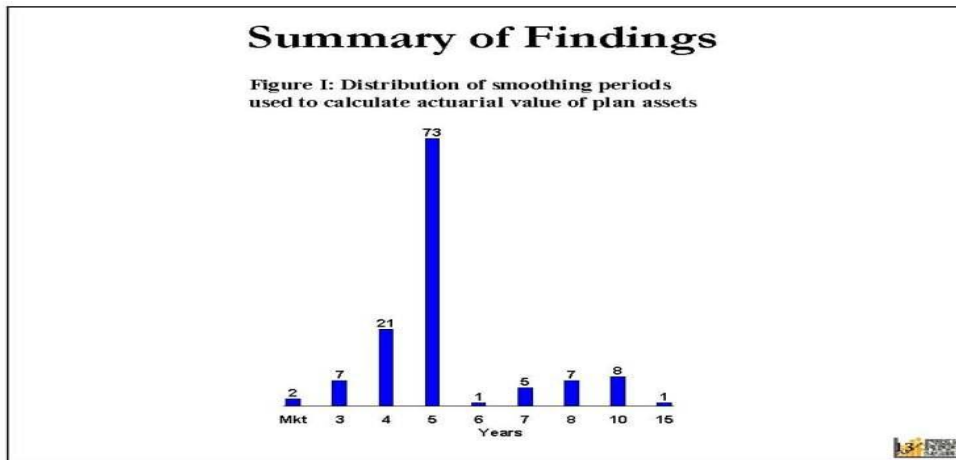
Under Utah's Tier I retirement plan, retirees are guaranteed an automatic COLA equal to the smaller of the CPI or 4%. Retirees receive the COLA regardless of the condition of the fund. The guaranteed COLA for Idaho's retirees is the smaller of the CPI-U (CPI for urban consumers) or 1%. The PERSI Board has the discretion to grant a higher COLA if the CPI-U is more than 1%, but has the fiduciary responsibility to act in the best interest of the fund.

Smoothing

Another important difference between Utah and Idaho is that PERSI does not use smoothing when reporting investment gains or losses. Smoothing is a technique used to temper sharp gains or losses by spreading them over a longer period of time. The objective for smoothing is to reduce volatility in the funding status. Since contribution requirements are determined annually, volatility in funding status causes volatility in contribution requirements and, therefore, contribution rates. The downside to smoothing is it masks the true picture of the funding status. This is one of the reasons Utah's UAAL is larger and still growing while Idaho's is shrinking, though funding status appears to be comparable for the systems prior to the market collapse. (Idaho's UAAL is currently \$1.4 billion.)

At the end of 2009, Utah reported an 85.7% funded status, with 5-year smoothing. In our rough estimation, their actual funded status was only 75% at the end of 2010.

Idaho is one of only two systems that do not “smooth” gains and losses. Idaho uses what is called “market value” of assets. The Public Pension Transparency Act being discussed in Congress addresses this topic. If passed, the act it will require all pension systems to report funding status at market value. This particular portion of the act will have no effect on Idaho since we already report market value.



Eliminating smoothing would also make comparison between systems easier. Currently, the majority of systems use several different smoothing factors, so comparing funding rates “apples-to-apples” is impossible. When Idaho says it is 78.9% funded, that is an actual and true number. Idaho cannot accurately be compared to any other system because of smoothing.

As you can see from the chart below, calendar year returns are similar for both systems. Due to smoothing, however, Utah’s actuarial rate of return is significantly different from the actual return. Since Utah uses a 5-year smoothing, its funding status will most likely continue to drop for the next 3 years to recover from 2008 losses.

	2006	2007	2008	2009	2010
Idaho	15.9%	10.4%	-25.3%	23.1%	10.8%
Utah Actual	14.7%	7.3%	-22.3%	12.8%	13.7%
Utah Smoothed	11.1%	13.04%	-5.03%	6.1%	TBD

Economic Assumptions

Public pension actuaries determine the funding status and cost of a public pension plan using assumptions about future events that affect the pension plan, such as rates of inflation and wage growth, participants’ age at retirement and mortality, and investment returns on the plan’s assets.

The net rate of return assumption is the projected investment return after expenses. A recent survey of 125 public pension systems by the National Association of State Retirement Administrators (NASRA) found 8.0% is most commonly used; however, some systems use the rate before expenses are deducted, so it is difficult to compare systems. It is reasonable to say PERSI’s assumption of 7.25% is conservative compared to most systems.

The inflation assumption projects the rate of inflation for the general economy as a whole. The NASRA survey found the average inflation assumption to be 3.5%, which matches what PERSI uses.

The salary increase assumption is important because benefits are based on members’ earnings just before retirement, so actuaries must incorporate future salary projections into the valuation process. A

study of public pension plan assumptions by Callan Associates shows the rate ranges from 2.5% to 5.5%, with 4.0% being the most common.

The real return is equal to the net rate of return minus the inflation rate. The study by Callan Associates determined the average real return assumption to be 4.5%. The PERSI assumption of 3.75% is more conservative for both the average and the URS assumption of 4.75%. This is another reason PERSI can withstand economic turmoil better than URS.

	Net Rate of Return	Inflation	Salary Increase	Real Return
Idaho	7.25%	3.5%	4.0%	3.75%
Utah	7.75%*	3.0%	4.0%	4.75%

URS Ongoing Challenges

To avoid raising contribution rates on the old system last year, the Utah legislature increased the corridor for smoothing, giving them a longer time period to recognize market losses. It also increased the amortization period from 20 to 25 years and changed the amortization method from open to closed system. These changes buy URS some time before they will be required to make changes to bring the fund back into compliance with the law.

SB 63 puts measures in place so new hires don't add to URS' funding problems, but it initially does nothing to reduce the current UAAL. The 4% contributions on new hires will have no material effect on the UAAL for many years. URS must still resolve the funding situation, a challenge that will probably require contribution rate increases on Tier I employees. Given the current economic condition and employers' budget situations, it is difficult to increase contribution rates. It may be necessary to further extend the amortization period or adjust other assumptions, moves that will push the problems further into the future.

Conclusion

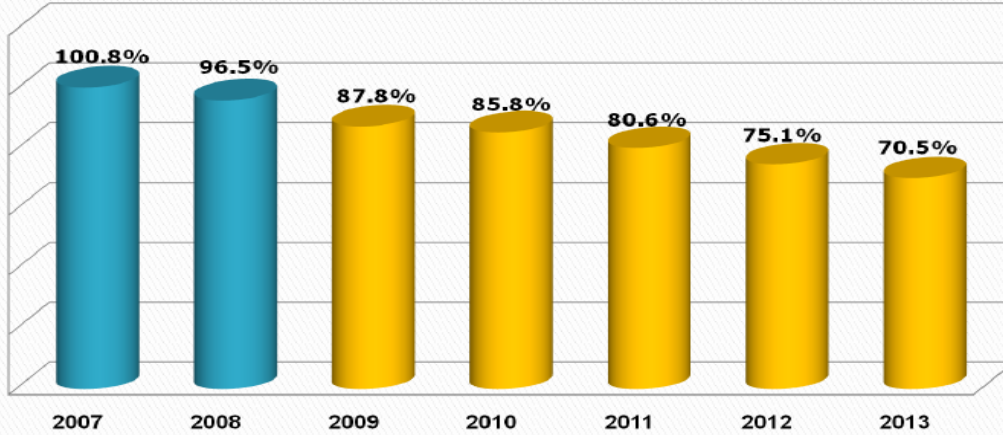
At this time it is impossible to project when the new system will begin to save the state money. Employer contribution rates will continue to rise to pay off the unfunded liability. Currently employers are paying 14%, but this will very likely increase in the near future as the 2010 Actuarial Valuation is completed.

One source stated that passage of SB 63 came with a promise to raise wages for state new hires to offset the lower pension promise. However, given the current economic and budgetary issues it still remains to be seen if this is possible.

The following charts provide a final comparison showing the marked difference between the current and future financial situations of the retirement systems in Idaho and Utah. The projected funding status for both states assumes a rate of return equal to Utah's current actuarial assumption (7.75%) and contribution rates are locked in at each state's 2010 rates.

The employer contribution rate chart also assumes a rate of return of 7.75%.

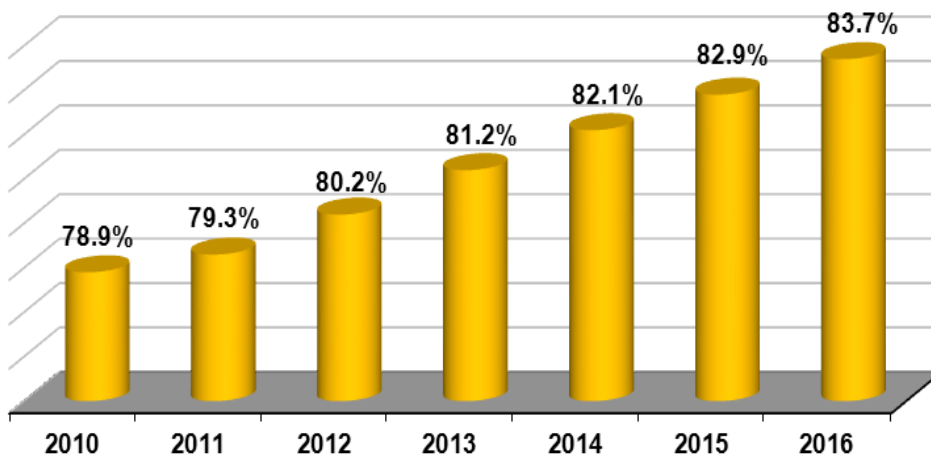
Utah's Projected Funded Ratio



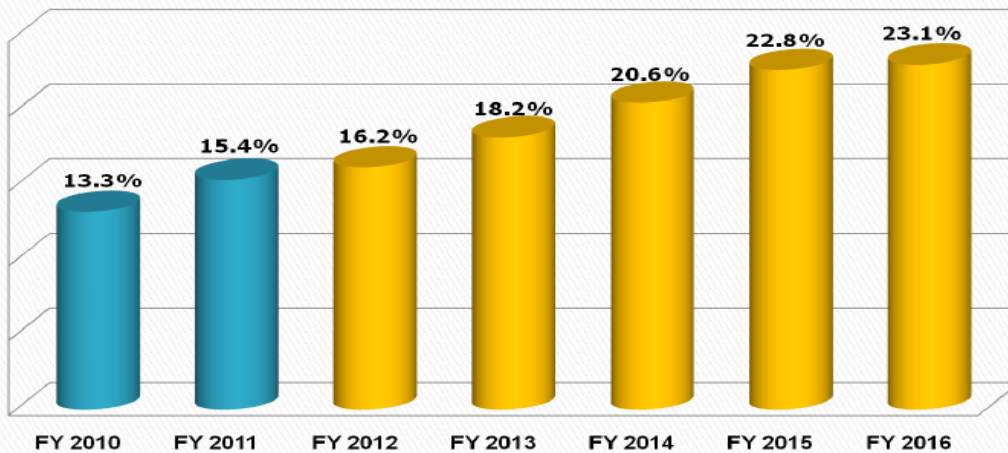
Source: Utah Retirement Systems Comprehensive Annual Financial Reports - 2000-2009 - for year ending Dec. 31; and Memo to the Honorable Daniel R. Liljenquist, Senate Chair, from Gabriel Roeder Smith & Company, November 10, 2009.

Source: NCSL Presentation by Senator Liljenquist

Idaho's Projected Funding Ratio



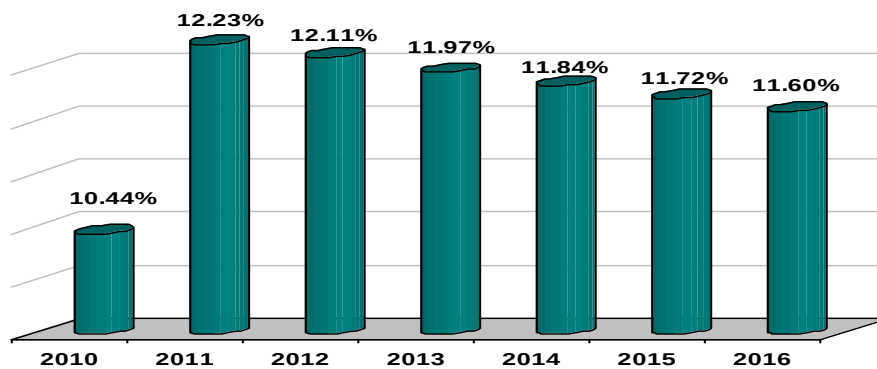
Utah's Projected Employer Contribution Rates



Source: Utah Retirement Systems Comprehensive Annual Financial Reports - 2000-2009 - for year ending Dec. 31; and Memo to the Honorable Daniel R. Liljenquist, Senate Chair, from Gabriel Roeder Smith & Company, November 10, 2009.

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Idaho's Projected Employer Contribution Rates



Not requiring employees to contribute to the plan, having an aggressive investment policy, and utilizing smoothing, have created instability in some pension plans. We do not disagree Utah had to do something to sustain its retirement plan. Many states are in the same situation as Utah and must act to continue a viable plan.

This comparison, however, shows how Idaho's conservative investment and benefit policies have served the state well. The Idaho Legislature and the PERSI Retirement Board created a sustainable plan from the beginning and have not wavered in that mission. They made hard decisions all along so they wouldn't have to make them later.