**Briefing Paper: Principles and Guidelines for Public Employee Retirement Systems**

Prepared for the State Administration and Veterans' Affairs Interim Committee (SAVA) by
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## BACKGROUND

Long before the advent of the current State Administration and Veterans' Affairs Interim Committee (SAVA), other interim committees existed to monitor, study, and recommend changes to the state's various public employee retirement systems. To aid them in their work, those committees established general principles for the retirement systems. The principles have been updated and adopted by each successive committee with oversight over the public employees retirement systems.

Currently, SAVA is required by Section 5-5-228(2), MCA, to "establish principles of sound fiscal and public policy as guidelines." The principles should be used to evaluate proposed changes to the systems to ensure that the systems' designs remain consistent with "sound policy principles."

Past SAVA committees have also adopted additional "guidelines," 24 in total. These guidelines add detail to the broader outline of the principles. Many of the specific guidelines are also reflected in statute.

Because SAVA is also required by 5-5-228(2), MCA, to "solicit and review" any proposed statutory changes to the state's retirement systems, these principles and guidelines provide a benchmark against which the Committee, public employees and other interested stakeholders, taxpayers, the general public, and ultimately the Legislature can measure proposed changes to Montana's retirement systems.

## PRINCIPLES

I. Pensions should provide the base of financial security in retirement.
II. Pension funding should be a contemporary obligation.
III. Pension investments should be governed by the Prudent Expert Rule.
IV. Pension benefits should be equitably allocated among beneficiaries.

The four current principles have their origin in work done by the National Conference of State Legislatures (NCSL) Working Group on Pensions, which was part of the larger Fiscal, Oversight and Intergovernmental Affairs Committee in the 1980s and 1990s. Previous SAVA committees have amended the principles to align with their goals for and views of the Montana retirement systems; in large part, though, the four principles remain similar to those originally established to guide oversight of public retirement systems.

In general, the principles serve as SAVA's answers to four fundamental questions about public retirement systems:

- What purpose should pensions serve?
- Who should fund public pensions?

- What standards should govern investment of pension assets?
- How should pension benefits be allocated among beneficiaries?[1]

*Principle I: Pensions should provide the base of financial security in retirement.*

Principle I originally read "Pensions should provide financial security in retirement." In 1998, the Committee on Public Employee Retirement Systems (CPERS) added "the base of" to the principle, thus amending the meaning. Essentially, this principle states that at the end of a working career (not just employment), a pension from an employer should provide a source of some (but not all) of the retirement income a person will need to have financial security, with "financial security" meaning a floor of benefits.[2]

*Principle II: Pension funding should be a contemporary obligation.*

Principle II states that funding pension is the obligation of the public employers, employees, and people receiving the services provided by the public employees at the time those services are provided.[3] It means that the cost of providing pension for current workers should not be deferred to future taxpayers. Contribution amounts should be set with consideration of what the tomorrow's costs will be to provide a benefit to today's public worker.

This principle contrasts with a "pay-as-you-go" system, in which retirement benefits are paid for after the worker has retired and the benefits have been earned, a type of system rare in public retirement plans. It also discourages "ad-hoc" increases that add to an employee's benefit without a corresponding increase in contributions from the employer or the employee to cover the cost of providing the increased benefit.

Principle II also doesn't mean that the existence of an unfunded liability in a defined benefit plan is necessarily problematic. Built into a plan's actuarial assumptions is the idea that earnings from the investment of employer and employee contributions -- and investment earnings on previous earnings -- will contribute to funding retirement benefits. Over a set period of time, these three elements -- employer and employee contributions and investment earnings -- should combine to pay off the cost of the current workers' future benefits as currently defined, thus meeting the standard that pension funding should be a contemporary obligation. Section 19-2-409, MCA, sets out this time period as no more than 30 years.[4]

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[1] *Public Pensions: A Legislator's Guide*, National Conference on State Legislatures, The NCSL Working Group on Pensions of the Fiscal, Oversight and Intergovernmental Affairs Committee, July 1995.

[2] Ibid.

[3] Ibid.

[4] Article VIII, Section 15 of the Montana Constitution requires retirement systems to be funded on an "actuarially sound basis." Section 19-2-409, MCA, clarifies the meaning of this requirement, saying "actuarially sound basis means that contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. For a defined benefit plan, the full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing the unfunded liability over no more than 30 years. For a defined contribution plan, the full actuarial cost is the contribution defined by law that is payable to an account on behalf of the member."

*Principle III: Pension investments should be governed by the Prudent Expert Rule.*

Principle III sets the standard for how pension assets should be invested. It was modified from the original language ("prudent person") to mirror language added in 1994 by Constitutional Amendment No. 25 to Article VIII, Section 13(3), of the Montana Constitution. This subsection requires retirement system assets "to be managed in a fiduciary capacity in the same manner that a prudent expert acting in a fiduciary capacity and familiar with the circumstances would use in the conduct of an enterprise of a similar character with similar aims." The language in the Montana Constitution is similar to the language Congress set to govern the standard of care for fiduciaries in the Employment Retirement Income Security Act of 1974 (ERISA) in what is called the "Prudent Investor Rule." All 50 states use some version of this rule to govern the investment of their pension assets.[5]

*Principle IV: Pension benefits should be equitably allocated among beneficiaries.*

Generally, this principle can be followed simply by keeping retirement plans Internal Revenue Service (IRS) compliant. Regulations exist to prevent discrimination between employees based on age or earnings. A state's retirement plan should not discriminate against those who earn less or start late. The NCSL Working Group also advises ending provisions "that unreasonably differentiate" between groups of employees, giving latitude for different retirement plans to have different formulas for determining benefits, depending on the rationale behind the formula. This principle also covers the areas of portability and vesting, issues which most Legislatures have worked hard to address.

## GUIDELINES

The 24 guidelines adopted by previous SAVA committees provide additional detail and standards to assist the Legislature when providing general oversight over the state's retirement systems and reviewing any proposed changes to those systems. As with the principles, they can be amended, deleted or supplemented with new guidelines at the discretion of the Committee.

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[5] *Public Pensions: A Legislator's Guide*, National Conference on State Legislatures, The NCSL Working Group on Pensions of the Fiscal, Oversight and Intergovernmental Affairs Committee, July 1995.