Colorado's Pension Liability

The Public Employees Retirement Association (PERA), created in 1931, is the state's largest pension plan with more than 441,000 members in 2009. Although PERA boasts assets with market value of $32.9 billion,[1] its total liabilities were nearly twice that amount – $56.3 billion – even after the legislature adopted the latest PERA bailout: Senate Bill 1 (2010). That legislation reduced PERA's long-term liabilities and increased contributions from both taxpayers and employees by as much as $160 million annually.[2]

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A pension plan's "funding ratio" is an estimate of the actuarial value of a plan's assets versus its liabilities. At one extreme, a ratio of 0 percent would mean a plan has promised a benefit and has no assets to pay for it. A ratio of 100 percent would mean a plan is on track to have the actual assets needed to pay out the benefits when they come due. From 1970 to 2000, PERA's funding ratio steadily climbed from 55 percent to a high of 105 percent. As PERA's funding improved, state lawmakers and the PERA Board of Directors backed various policy changes that increased benefits, allowed members to purchase additional years of service at below cost, and reduced the employer contribution rate from 12.15 percent to 10.15 percent.

The market retrenchment of the early 2000s cost PERA an estimated $6.8 billion in investment assets through 2004. In the wake of the 2008 credit crisis, PERA lost another $12.3 billion in market assets. In just eight years, the market value of PERA's assets had fallen to less than 52 percent of its liabilities — a shortfall of $27.5 billion. The steady fiscal improvement that the plan had made over a 30-year period was wiped out in just eight years. Now, the costs of the extra benefits that were added during a time when the plan was just becoming fully funded are exacerbating the problem.

Even PERA began to acknowledge drastic changes were needed: "The combination of the dramatic losses due to the financial markets along with the cumulative effect of contribution shortfalls in the last five years and benefit enhancements in the 1990s, bring into question the long-term sustainability of the (fund)."[3]

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Prior to 2008, PERA officials routinely brushed off assertions that its ability to pay members' benefits was in jeopardy, although independent actuaries had told PERA, "If there is not a sufficient recovery in the investment markets in the near future, the long-term ability of (PERA) to support the benefits will be challenged . . . ."[4] As late as October 2009, PERA spokeswoman Katie Kaufmanis told the Associated Press that PERA has $32 billion in assets and will still be able to pay benefits for many years.

Within three months, however, PERA was singing a different tune. Sponsors of the PERA-supported Senate Bill 1 (2010) warned that without significant changes, including immediate benefit reductions, the fund could go broke within 20 years.[5]

Senate Bill 1 made some long overdue changes:

- For the first time, PERA's legal staff abandoned the contention that certain benefit enhancements, like cost of living adjustments (COLAs), were irreversible and could never be scaled back for current retirees or for members who are "fully vested" (i.e., who have more than five years' experience). Retirees' annual COLA was capped at the lesser of 2 percent or the annual rate of inflation.

- PERA retirees were required to continue to contribute the employees' share to the fund if, while "retired," they work for a PERA-covered employer. Previously, PERA retirees could collect their retirement benefits while working at their former job "part-time" and not contributing to the fund. This provision exacerbated PERA's funding shortfall because the "retired" worker was collecting benefits but likely displacing a younger worker who would have contributed to PERA's trust fund.

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- Members seeking to maximize their highest average salary to increase their monthly retirement benefit were limited in their salary "spiking" ability. Retirement benefits had been calculated based on highest average salary over the members' last 36 months of employment. Senate Bill 1 spread the calculation over 60 months and capped year-to-year salary increases during that period at no more than 8 percent.

However, the bill stopped short on several important measures that would protect taxpayers and promote equity between workers in the public and private sectors:

- Even under Senate Bill 1, current PERA members can retire at age 55, and those hired after Jan. 1, 2011, can retire at age 58. By contrast, private sector workers who were born in 1960 or later, must wait until age 67 to retire with full benefits under Social Security.

Increasing the retirement age is necessary to promote a sense of fairness between taxpayers whose tax dollars pay the overwhelming share of employer contributions to PERA. Asking private sector workers to work longer so that public sector workers can retire earlier simply does not wash. Moreover, increasing the retirement age would decrease PERA's actuarial liability in the same way that increasing the deductible on an auto or health insurance policy reduces the premium.

In reality, pension plans like PERA or Social Security provide "retirement insurance" to their members. Actuaries necessarily account for their members' average life expectancy after retirement, and calculate the funds necessary to pay benefits for that period.

A PERA member's average age at retirement is 58.[6] According to the U.S. Department of Health and Human Services, a 58-year-old male can expect to live another 20.4 years and a 58-year-old female can expect to live another 24.6 years — an approximate average of 22.5 years, or to age 81. By contrast, a 67-year-old male can expect to live another 14.8 years and a female another 18.4 years — an approximate average of 16.6 years.[7]

By linking PERA's retirement age to that of Social Security (at least for current PERA members under age 35 and for all new hires), PERA could reduce the duration of its retirement benefits from an expected average of 22.5 years per affected retiree to 16.6 years – a reduction of 5.9 years; or approximately 26 percent. Raising the retirement age also would have the benefit of deferring the expected payout period by nine years if the retirement age were raised from 58 to the private sector's age of 67 years. If combined, both of these factors could reduce the costs for the affected portion of the plan by 20 percent to 35 percent.

Although the complexity of PERA's benefit structure and actuarial assumptions eschew back-of-the-envelope calculations, any change that would reduce by one-fourth the cost of benefits to future retirees would be a significant step toward making PERA sustainable and reducing the burden on young workers to pay both the cost of their own retirement and that of current retirees.

A key policy question for lawmakers to consider is whether PERA should be a plan that supports workers in retirement or an investment plan that provides supplemental income to able-bodied workers before they actually retire.

Incidentally, a favorite retort of those who oppose retirement equity goes something like this, "You don't want a 64-year-old teacher in the classroom." In reality, raising the PERA retirement age would not force anyone but the most highly-paid public workers to work longer. Many PERA members, who retire in their late 50s, either work part-time for their former employer or take a job that is not covered by PERA, thereby allowing them to collect both a salary and retirement. A key policy question for lawmakers to consider is whether PERA should be a plan that supports workers in retirement or an investment plan that provides supplemental income to able-bodied workers before they actually retire.

- When fully implemented, Senate Bill 1 and previous PERA bailouts will increase the total contribution to PERA on behalf of its members to 28.15 percent of payroll — of which, 8 percent is paid directly by employees, 10.15 percent by employers, and another 10 percent paid by employers in the form of amortization equalization disbursements (AEDs) and supplemental AEDs (SAEDs). According to law, the SAEDs are to be paid from wage increases withheld from employees. However, for the past two years, SAED payments by employers increased despite the fact that no salary increases were provided to state workers; thus the SAED came at the expense of other budget priorities.[8]

The long-term impact of these bailouts is costly, not just to the state, school districts and other PERA employers, but also to PERA members. Employers must pay PERA an annual contribution equal to 20.15 percent of each employee's salary. Because government budgets are limited, this bailout burden inevitably suppresses wages of public employees, resulting in younger workers paying both the cost of their own retirement and that of current retirees. Compounding the inequity is the decreasing ratio of current workers to current retirees. Thirty years ago, working PERA members outnumbered retirees by 5.6-to-1. Today, the ratio is just over 2-to-1. In 25 years, the ratio will be closer to 1.2.-to-1. As life expectancies increase, many PERA members may spend as much time collecting benefits as working in a PERA-covered job. Unless the retirement age is increased to reflect this increased longevity, PERA's demographic spiral will continue downward.

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- Despite contributing more than $1.2 billion a year for PERA to be invested at the direction of PERA's Board of Directors, Colorado taxpayers still may remain contractually obligated to further attempts to rescue PERA from future market downturns and a costly benefit structure. Taxpayers need to know that, at a specific point, they have fulfilled their obligation to provide for public employees' retirements and that thereafter the responsibility rests with the employees and their elected Board of Trustees.

Although the performance of PERA's investments generally has exceeded their benchmarks, its cash flow needs demand that it beat the market year after year — a task that eventually baffles even the best mutual fund managers. "The most important long-run driver of a pension plan is investment income, which can contribute as much as 80 percent or more of the total inflows into a pension plan over its life," PERA states in its 2008 annual report.

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As a result of these cash flow pressures, PERA's Board of Trustees has adopted an investment strategy that assumes an 8 percent return on investment (ROI) — revised from 8.5 percent as recently as 2008. Ironically, this small nod to prudence adversely affected PERA's funding ratio. Without the compounding power of that additional one-half percent, PERA's ability to meet its projected liabilities fell by $3.5 billion and reduced the funded status of its state division by 3.9 percent.

While the current reported average rate of return assumption is 8.0 percent, it could easily be argued that this is still too high. This 8.0 percent is based upon projections for "Real Rate of Return," "Inflation" and "Expenses." A brief review of these assumptions could lead one to believe that a Return on Investment assumption of 8.0 percent, though reduced by 0.50 percent from the prior year, is still too optimistic.

While the chief actuary for the Social Security OASDI plan chose an assumption of 2.8 percent for inflation, in 2008 the PERA valuation used 3.75 percent, which is at the high end of its own stated "reasonable range" of 2.0 percent-4.0 percent. This higher estimate for inflation pushes the overall investment assumption up to 4.56% + 3.75% - 0.40% = 7.91%, which was rounded up to 8.0 percent. If PERA were to use the same inflation assumption as Social Security, the investment assumption would only be 7.0 percent. Apparently, such an adjustment would be too much bad news for the PERA board to bear, since it would reduce PERA's ability to meet its projected liabilities by another $7 billion, and reduce the funded status of its state division by another 8 percent. PERA's investment staff is under constant pressure to invest aggressively because a more conservative strategy will rarely achieve the necessary ROI. PERA's investment strategy allocates its funds as follows:

- Domestic equity: 43 percent
- Fixed income: 25 percent
- International equity: 15 percent
- Alternative investments: 7 percent
- Real estate: 7 percent
- Opportunity fund: 3 percent

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In 2009, PERA paid out $3.24 billion in benefits and received $2.22 billion in contributions from members and employers. The difference, $1.02 billion, must come from return on investment (ROI), or else PERA is forced to dip into its trust fund to pay benefits. Withdrawals from the trust fund are gone forever; they cannot be reinvested and cannot generate interest or dividends in the future. Put another way, PERA needs approximately 4 percent ROI just for cash flow; only returns exceeding that rate can be reinvested.

Cost to State and other PERA Employers

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Accurately estimating this cost is difficult. As of 2009, employees working in PERA-covered jobs accounted for more than $7.0 billion in total payroll.[9] A one percent increase or decrease in contribution rates would vary spending by $70 million.

However, only a portion of PERA-covered workers are dependent upon salaries paid directly or indirectly through the state budget. A litany of quasi-government entities and associations of governmental entities have also been added to PERA, at their request, over the years. These ancillary PERA employers include, among many others: CollegeInvest, Colorado Association of School Boards, the Colorado High School Activities Association, Pinnacol Assurance, and the Special District Association of Colorado.

Moreover, even the legislature's Joint Budget Committee doesn't have direct access to the direct cost of PERA employment for state workers. Governor Bill Ritter's administration recently changed the format of the payroll information transmitted to the legislature with its budget requests, aggregating the amount for salaries and benefits and eliminating the specific line item for each subcategory. The best available information available for estimating the PERA's payroll costs to state government—not including schools—comes from Senate Bill 146 (2010), in which the legislature shifted 2.5 percent of the PERA contributions from employers to employees for the 2010-11 fiscal year.[10] (That bill estimates the savings to state government at $37.2 million for one year; thus, one percent of payroll for state workers under PERA can be estimated at approximately $14.9 million.) Although it won't be fully implemented until 2017, the current cost of PERA's bailout plan, were it to be fully if implemented in 2011, would be $149 million, just for state government.

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To put that amount in context, $149 million exceeds the cost of all tax increases ($102.9 million) approved by the legislature as part of its 2010-11 budget-balancing package. It also exceeds the combined general fund expenditures for the departments of Agriculture, Law, Local Affairs, Military Affairs, Natural Resources, Personnel, Public Health and Environment, Regulatory Agencies and Treasury, as well as the Governor's Office and the Legislature, all of which combine to total $141.3 million.

The impact on school finance is larger still. Most recent available data (from 2008) place the total annual payroll in the school division at $3.8 billion, so the bailout cost (10 percent of payroll) for the school division will ultimately rise to more than $380 million annually. Although this cost is paid by local school districts, those districts receive more than 60 percent of their funding from the state legislature and most of the balance from local property taxes. Each district's PERA contribution detracts from its ability to put more resources into the classroom, increase stated salaries for quality teachers or both.

The tradeoff between rescuing PERA and funding public education is clear. To balance the 2010-11 state budget, the legislature reduced total K-12 public education funding by $382 million —

almost exactly the amount that the PERA bailout will require of employers in the School Division when fully implemented.

For 2011, the bailout cost just for public schools comes to an estimated $174 million. For comparison, the cost of Governor Ritter's 2007 property tax increase, which forced most school districts to collect more tax revenue locally is $160 million.[11] Subtract the cost of the PERA bailout and more money would be available for local school districts even without higher property taxes.

These costs will escalate as the number of teachers and state employees increase and as salaries grow — until such time as PERA exceeds a 103 percent funding ratio, which has happened only once in the fund's 79-year history. Worse still, ample evidence suggests that Senate Bill 1, combined with previous "rescue" plans, is unlikely to achieve the professed goal of helping PERA reach fully-funded status—as government accounting rules require of pension plans in the private sector.

PERA's 2009 Certified Annual Financial Report confirms that the Board of Trustees' assumed future rate of return (ROR) greatly affects the funding ratio. Of course, the assumed rate of return is an attempt to estimate future returns, not something beneficiaries or taxpayers can take to the bank. When the Board of Trustees reduced the ROR assumption from 8.5 percent to 8.0 percent in 2008, PERA's unfunded liability, on paper, increased by $3.5 billion. If trustees were to assume a conservative return of 4 percent—which might seem optimistic in the current environment—the cost on paper likely would approach $40 billion.

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Of course, more important than the Trustees' assumption is the actual rate of return. The state has a contractual obligation under the Colorado constitution to ensure PERA members receive the benefits they have earned. Whether that applies to perpetual cost-of-living increases or bans the reconsideration of retroactive benefit increases is a legal question likely to be resolved through the courts in the wake of Senate Bill 1. However, PERA members are, at a minimum, entitled to a benefit calculated based on their years of employment and average salary.

Policy Proposals

1. ***Require PERA to create separate pension fund for "new hires."*** Under PERA's current funding structure, young workers and those hired in the next three decades will pay a large share of the cost of providing pension benefits for today's retirees and workers nearing retirement age. This structure penalizes younger workers in two ways: First, younger workers will be paid less. Secondly, as younger workers later near retirement, their salaries will remain suppressed until such time as PERA's funding ratio reaches 103 percent, which has happened only once in 79 years.

   The contributions of new hires should be segregated into a new trust fund, from which their benefits alone—not the benefits of older retirees—should be paid. This fund's model must be based on a benefit structure that is sustainable, including many of the cost-control features included in Senate Bill 1 (2010), and retirement age must be linked to that of Social Security.

   Current PERA members who are at least 20 years from retirement should be given the opportunity to join the new hires fund, too.

2. *Specifically identify "bailout" costs.* PERA uses the complexity of its current pension system, which relies on contributions from today's workers to ensure benefits of today's retirees, to conflate the costs of bailing out PERA's financial losses with the cost of current benefits with the cost of paying benefits for today's younger workers when they reach retirement age.

Creating a new hires fund will enable lawmakers to identify the specific costs of a new system that includes adequate cost controls, the costs of providing benefits to current retirees, and the cost of subsidizing PERA's recent financial losses.

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By isolating these costs, lawmakers can be sure that they aren't simply digging a deeper hole and transferring the cost to future workers and future legislatures.

3. *Sunset the AED and SAED payments to make PERA accountable for reaching fully-funded status.* Under current law, PERA expects the state and local school districts to continue making bailout payments (AED and SAED contributions) for at least 24 years in the State Division and 23 years in the School Division. By that time, each seat in the State Senate and State House will change hands at least four times, and most of PERA's current officials will be retired, as well. As a result, there is virtually no accountability built into the current system to ensure the current bailout plan does not extend for an additional two, six or 10 years, taking billions more away from other priorities, like education, transportation and public safety.

4. *Relieve taxpayers from the responsibility of future bailouts.* In the past decade, lawmakers have passed three bills designed to rescue PERA from investment losses and costly benefits. Only the last bill took significant steps to reduce the future cost of benefits, but all three obligated employers or employees to pay still more to help PERA attain solvency. Even after the latest "fix," Senate Bill 1 (2010), PERA does not expect to fully amortize its liabilities for 16 to 65 years. To reach that goal, PERA needs an average return on investment of 8.0 percent per year.

Under current law, if PERA's investments fail to realize those lofty projections taxpayers are still on the hook to make PERA whole, even though taxpayers have no control over PERA's investment choices. It's time to end this "heads we win, tails you lose" racket. Taxpayers cannot afford it, and neither can young employees whose earnings are reduced in order to fully fund the retirement of current and pending beneficiaries.

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If PERA's investments fail to achieve returns necessary to pay benefits, then lawmakers should require PERA's Board of Trustees to equitably reduce the cost of benefits to all members—not simply increase the burden on younger workers.

The state, public schools and young public employees can scarcely afford the current schedule of bailout payments, which take funds from other budget priorities. Additional bailout payments must be off the table, and PERA must be required to return to funding its pension plan from contributions which are affordable and sustainable both to employers and employees.

5. ***Link the retirement age to Social Security.*** Linking the retirement age for PERA members to that of Social Security would restore equity between taxpayers and the government employees whose salaries and retirement benefits taxpayers help finance. It's simply unfair to expect ordinary Coloradans to work longer to bail out a pension plan that allows state workers to retire as early as age 50 or 55. Just as importantly, this policy change could significantly reduce future benefit costs.

FIRE & POLICE PENSION ASSOCIATION (FPPA)

In 1978, the state legislature and local municipal officials created the Fire and Police Pension Association (FPPA) to provide uniform adequate funding for local fire and police pension funds—all of which had been managed locally and accrued a combined unfunded liability of more than $500 million.

To address the unfunded liability for existing fire and police pensioners and ensure proper funding of pensions in the future, the state separated FPPA into two funds: 1) the "old hires" fund, covering those police officers and firefighters hired prior to April 8, 1978, and 2) a "new hires" fund for those hired on or after that date.

To address the unfunded liability for existing fire and police pensioners and ensure proper funding of pensions in the future, the state separated FPPA into two funds: 1) the "old hires" fund, covering those police officers and firefighters hired prior to April 8, 1978, and 2) a "new hires" fund for those hired on or after that date.

The state and each of 110 local governments responsible for pension benefits under the old hires plan agreed to a schedule of payments to eliminate the unfunded liability in 30 years (2009-10) or when the plan became fully funded, whichever came first. Since 1980, the state has paid nearly $538 million toward its share of the agreement, and local governments have paid just over $540 million. During three periods of budget shortfalls, the state has suspended its payments for a total of seven years (1987, 2003, 2004, 2005, 2009, 2010 and 2011), although those omissions have been subsequently replaced or scheduled as additional years. Currently, the state's remaining obligations total some $160 million to be paid by 2015.

Learning from those mistakes, the state created a new hires plan that has been fully funded since its inception, according to FPPA's annual report for 2009. Even after the stock market collapse in 2008, FPPA remained funded at 101 percent of future liabilities, in part because it had increased its assets to as much as 122.5 percent of liabilities as recently as 2007.

FPPA's structure includes many safeguards created to avert future unfunded liabilities:

- ***No guaranteed COLA.*** FPPA's Board of Directors determine each year whether sufficient funds exist to pay for a COLA of 3 percent or less.

- ***Retirement age flexibility.*** Although the standard retirement age under FPPA is age 55 with 25 years of service, members who have 30 years of service by age 50 may retire early but receive reduced benefits. Further, the Board of Directors may raise the retirement age to 60 if actuarially necessary. (Incidentally, the rationale for allowing retirement at age 55 or 60 for employees in high risk fields, such as police and fire protection, is far more sound than allowing retirement at those ages for government employees in jobs that don't regularly require significant strength and stamina.)

- ***Stabilization Reserve Account (SRA)***. When FPPA's defined benefit plan is fully funded, excess contributions (i.e., those in excess of the amount needed to pay benefits) are deposited into a Stabilization Reserve Account that includes separate accounts for reach member. According to FPPA's 2009 Annual Update, in any year in which employer and member contributions are insufficient to fund benefits, the shortfall "must be taken out of the SRA accounts" before contribution rates may be increased. This contingency has never happened but remains an important safeguard of the plan.

- ***Actuarial necessity.*** When a funding shortfall occurs, state law requires funds to be withdrawn from the SRA to make up the difference. If an actuarial shortfall remains, then benefit formulas must be reduced and the retirement age increased.

- ***Contribution stability and equity.*** Both member and employer contribution rates have remained at 8.0 percent of payroll since the plan's inception in 1980. State law requires that members' and employers' contributions be equal.

- ***Governance and conflicts of interest.*** FPPA's Board is divided into nine members, all appointed by the Governor and confirmed by the Colorado Senate. Three board members represent the plan's beneficiaries; three represent employers; and three are private citizens with a specific area of expertise. Moreover, FPPA staff does not participate in the defined benefit plan.

(Resources: Annual Update to the Pension Reform Commission, August 7, 2009, Fire and Police Pension Association of Colorado; FY 2010-11 Staff Budget Briefing, Department of Treasury, prepared by David Meng, Joint Budget Committee Staff, November 12, 2009; Funding of Fire and Police Pensions: 1903-2009, Colorado Municipal League, August 14, 2009.)

Acknowledgements

The Honorable Mark Hillman wrote this section. See his biographical material in the authors section.

We wish to thank **Richard Bratten** for conducting actuarial research for much of this section; the portion that was not drawn from PERA's research. Mr. Bratten is Partner of Bank Financial Services Group, a national firm specializing in non-qualified benefit plan design and funding. He holds designations as a Fellow, Society of Actuaries (FSA) and as a Chartered Financial Analyst (CFA Charter). He has 21 years of experience in the field after a first career teaching math and physics in high school. He is also the volunteer executive director of the Republican Study Committee of Colorado. He earned a degree in Education from the University of Cincinnati.

Notes

[1] PERA Certified Annual Financial Report (CAFR), December 31, 2009.
[2] "Final Fiscal Note" for Senate Bill 1, Colorado Legislative Council Staff, May 13, 2010.
[3] PERA Certified Annual Financial Report, December 31, 2008, pg. 18.
[4] PERA Update, February 28, 2006.
[5] "Colorado state pension changes given initial nod," 9NEWs.com, http://www.9news.com/rss/article.aspx?storyid=131557, Jan. 27, 2010, accessed

June 8, 2010

[6] CAFR, Dec. 31, 2008, pg. 122.

[7] Life Expectancy Tables, Department of Health and Human Services, 1996; http://www.efmoody.com/estate/lifeexpectancy.html.

[8] "Final Fiscal Note" for Senate Bill 1, Legislative Council Staff, May 13, 2010.

[9] PERA CAFR, Dec. 31, 2009.

[10] "Final Fiscal Note" for Senate Bill 146, Legislative Council Staff, May 13, 2010.

[11] "Revised Impact of Mill Levy Freeze," Legislative Council memorandum, June 18, 2009.