INDEPENDENCE INSTITUTE
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The Colorado Government Pension System
Introduction and Basic Organization

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Executive Summary

Colorado's Public Employee Retirement Association (PERA) is the State's largest pension plan, with more than 483,000 members as of 2011. Government contributions exceeded $1 billion in FY2011.[1]

PERA has assets of $37.5 billion, balanced against reported accrued liabilities of $62.5 billion, for an overall funded ratio of 59.9 percent and an unfunded liability of $25 billion. The liability translates into an obligation of nearly $13,000 for each of Colorado's two million households. In reality, the actual funded ratio may be significantly lower, and the unfunded liability for which the taxpayers are currently responsible may be much higher.

A number of different trust funds make up PERA, the largest being the School Division and the State Division, together comprising more than 80 percent of both its assets and liabilities. While this paper often refers to PERA's overall funded ratio, the PERA's various trust funds are not combined, nor does statute allow one division's assets to cover another's assets.

PERA's Basic Retirement Provisions

PERA is funded through both individual and state contributions to individual accounts. While there are variations for the different plans—Judicial, State Patrol, Denver Public Schools, et al.—this paper will focus on the State Trust, one of the largest trusts.

Individual employees contribute 8 percent of their incomes to their accounts, with the state contributing 10.15 percent. For fiscal years 2010 and 2011, 2.5 percentage points were shifted from the employer to the employee, making the respective contribution rates for those years 10.5 percent and 7.65 percent. The employees' contributions earn 3 percent interest.

The PERA benefit itself is calculated as a percentage of the employee's highest annual salaries for three different 12-month periods. The periods do not have to be calendar years, the last three years of employment, or even consecutive years. For employees who started after January 1, 2011, the year-over-year increase cannot exceed 8 percent. Prior to that, the year-over-year increase was limited to 15 percent.

The retirement age and service credit for full benefits has changed over the years. For those who obtained PERA membership in 2011 or later, the current structure allows for retirement at any age with 35 years of service, age 58 with 30 years of service, and at age 65 years with any number of years of service. By comparison, those who had less than 5 years of service prior to January 1, 2011, can apply for full benefits at 55 with 30 years of service, or at age 60 with 25 years of service.

In addition, an employee may apply for full benefits when his age plus service equals 85 years. This formula was raised in 2006 from the Rule of 80.

Until 2010, cost of living adjustments (COLAs) had been guaranteed at 3.5 percent per year. However, under Senate Bill 2010-001 (SB 1), the PERA reform bill, benefits were indexed to rise at 2 percent per year, or the rate of inflation, whichever is lower.

In 2012, PERA beneficiaries filed *Justus v. State*, claiming a contractual right to promised PERA

benefits under the Contracts Clauses of the US and Colorado Constitutions, as well as the Takings Clause of the US Constitution. The district court initially ruled for the state. However, on October 11, 2012, an appeals court reversed that decision, writing:[2]

> *Specifically, we conclude that plaintiffs have a contractual right, but that the court must still determine whether any impairment of the right is substantial and, if so, whether the reduction was reasonable and necessary to serve a significant and legitimate public purpose.*

Both sides have appealed to the State Supreme Court. The PERA recipients are appealing the idea that there can be "reasonable and necessary" circumstances that justify any reduction. The state is appealing the finding of a contractual right, is asking the Court to determine if the benefit reductions meet the tests set out by the appeals court, and is asking that the Court rule that the reductions do not constitute a regulatory taking.

Depending on how this matter is eventually resolved, the courts could end up making PERA's fiscal situation far worse.

Present Value, Future Value, Discount Rate

To understand how a defined benefit plan can be underfunded, it's important to understand the concepts of Present Value, Future Value, and Discount Rate. Don't worry, that's all the jargon we're going to introduce.

It's easy to see how a dollar today is worth more in the future. If you have a dollar in a savings account that pays 3 percent per year, then five years from now, you'll have $1.16. The Future Value of that dollar five years from now is $1.16.

Present Value is the same thing, only run in reverse. If you know that five years from now, you will have to pay $1.16, then instead of adding 3 percent each year, you remove, or "discount," 3 percent each year. That $1.16 you owe five years from now is said to have a Present Value of $1.00. If you only have $0.90 on-hand, then your account is said to be "underfunded" by 10 percent.

The interest rate you discount that $1.16 at is called the Discount Rate, and it's very important in determining whether or not you have enough money now to meet your expected obligations. Suppose that instead of using a 3 percent Discount Rate, you used a 5 percent Discount Rate. Then, the Present Value of that $1.16 would be only $0.90. In that case, the $0.90 you have on hand now would leave your plan fully funded.

A more detailed discussion with come in the second paper in our series, but suffice it to say for now that when PERA uses an artificially high discount rate of 8 percent, equal to its inflated expected rate of return, it masks its structural defects.

PERA as a Defined Benefit Plan

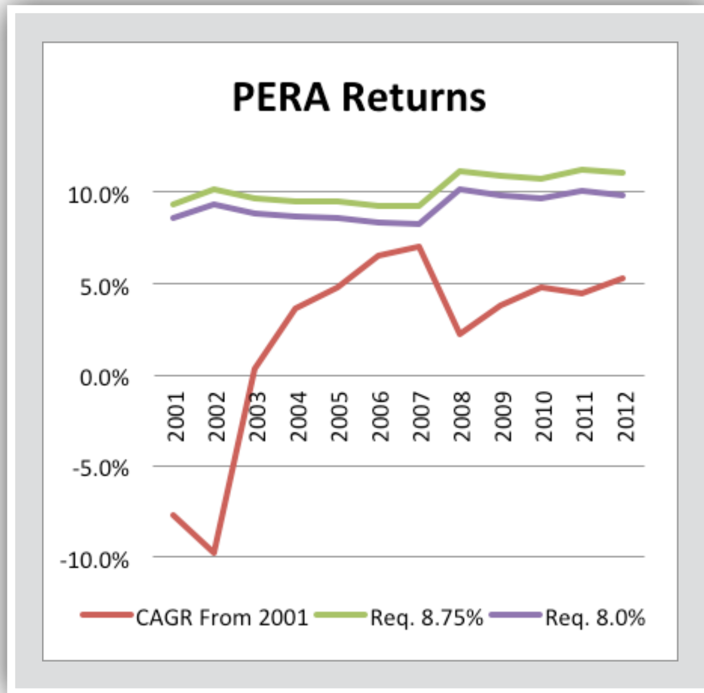
PERA is structured as a defined benefit plan; the benefits an employee receives at retirement are based on that employee's earnings and years of service. The plan may or may not have enough money to meet the expected benefit. If it does not have enough, the plan is said to be "underfunded," and will need to receive more money from taxpayers than had been planned to meet the promised benefits.

Conversely, in a defined contribution plan, contributions are made over time to individual accounts, which are then drawn down over the course of the employee's retirement. Benefits are determined by the balance in the employee's account. In essence, a defined contribution plan is always 100 percent funded, since the benefits can never exceed the amount in the employee's account.

Through actuarial tables for life expectancy, hiring, expected salaries, and people leaving and entering the program, PERA can predict with some accuracy what its obligations should be for its current and future members. By using a window of 30 years, and discounting the obligations back to today, one can know how much cash on hand is needed in order to meet those obligations. PERA does not expect to have all that cash now, but instead tries to match the future obligations against contributions over the next 30 years.

Based on that standard, PERA currently has an

unfunded liability of $25 billion, if it assumes an 8 percent annual return on its investment. Using more realistic assumptions, the unfunded portion of the liability is even higher. Therefore, even under PERA's optimistic scenario, it takes in $25 billion less than what is needed to meet future obligations.



In all likelihood, the unfunded liability is considerably higher. An 8 percent return is an optimistic—probably unrealistic—expected rate of return. Over the last 11 years, PERA's compound return has been under 5.0 percent.[3]

In 2001, PERA was projecting an 8.75 percent annual return. To average 8.75 percent for the years 2001-2030, PERA would need a return of 11.4 percent for the remaining 19 years. To average even 8 percent for the 30-year period, it would need a return of 10.1 percent through 2030. The chart includes an estimate of 2012's returns, based on PERA's close correlation with the California state pension system, which has already reported its 2012 performance.

PERA's Governance Structure

PERA's governance structure also contributes to its troubles. Almost every member of the board is also a member of PERA. This arrangement creates an incentive to try to maintain current benefits, even in the face of dismal accounting. Of the 16 board members, only three are appointed by the Governor, and one, the State Treasurer, serves ex officio. Thus, 12 of the board members, and a majority of virtually every committee, potentially are compromised by conflicts of interest.

Ultimately, Board members represent the people who elect them to the Board. Twelve members represent the interests of beneficiaries, with only four members left to balance the interests of PERA members with those of Colorado taxpayers.

The two most worrisome committees are the Benefits Committee, where members outnumber appointees 6-2, and the Audit Committee, where members outnumber appointees 4-3. Two additional Audit Committee members are external to PERA. Nevertheless, current corporate governance best practices would call for a significantly more independent Audit Committee.

As an example of the difficulties that the governance structure creates, State Treasurer Walker Stapleton (an ex officio PERA Board member) attempted to obtain benefit records concerning highly-compensated state workers. Even though the records would have been aggregated, the Board insisted the records would violate state employees' privacy. Stapleton sued the Board to obtain the records, but the courts have thus far ruled in PERA's favor. The ruling is going through the appeal process.

Nevertheless, PERA does make available a considerable amount of information concerning its financial structure and its overall fiscal health. It is required by law to compile an annual Comprehensive Annual Financial Report. That report is available online to the public at the PERA website, www.copera.org. The report contains not only financial projections and assumptions but also actuarial information necessary to evaluate the ability of the various funds to make their future payments.

PERA also recently announced the creation of the Colorado Mile High Fund[4], intended to invest in

entrepreneurial firms with other financial backing. Some entrepreneurs no doubt will be delighted to hear this news. But the new investment strategy undercuts the independence of these firms, and in effect, co-opts the most dynamic portion of the state's economy to lobby legislators and the public on behalf of its least dynamic sector, the government. In addition, it has the potential to raise considerably the risk profile of what ought to be a very conservative portfolio.

PERA's Fiscal Problems

Combined with the recent court ruling that potentially limits the ability of lawmakers to curb certain costly and unaffordable benefits, PERA's unfunded liability poses a serious and potentially crippling threat to Colorado's fiscal health.

PERA currently estimates the liability at $25 billion, but that number severely understates the actual amount. PERA assumes an 8 percent annual investment return, which seems optimistic for the foreseeable future. It discounts the future liabilities at that same 8 percent rate, making the unfunded liability seem smaller than it actually is. Actuarial calculations and the size of the total liability have been called into question by the Appeals Court's ruling. While it is true that the State of Colorado has made a habit of failing to contribute its Required Annual Contribution, PERA and the legislature simply have failed to create a benefit structure that can be supported, even if those contributions were 100 percent-funded.

The next paper in this series will address both specific calculations of the liability, and propose interim policy steps that can be taken to bring it under control.

Endnotes

[1] Unless otherwise noted, all financial data come from the PERA 2011 Comprehensive Annual Financial Report, https://www.copera.org/pdf/5/5-20-11.pdf.

[2] *Justus, et. al* v. Colorado, 2012 COA 169, (Colo. Ct. App. 2012).

[3] PERA 2001-2011 Comprehensive Annual Financial Reports, found from https://www.copera.org/pera/formspubs/reports.htm#peracafr.

[4] *Denver Post*, "Colorado PERA creates fund to invest in businesses in the state," October 18, 2012, http://www.denverpost.com/breakingnews/ci_21802400/colorado-pera-creates-fund-invest-businesses-state.

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