Court decision on pension cases expected soon - what will it mean for cities

The State Supreme Court will likely issue decisions soon in two key pension cases heard last fall. The impact could result in significant costs to cities participating in the Public Employees Retirement System (PERS). The cases stem from changes made by the Legislature to reduce the future costs associated with the pension system, and create more sustainability in the rate structure. The cases involve repealing gain-sharing and eliminating automatic COLA (cost of living adjustment) increases for some retirees. The lawsuits were brought by retirees who believe that these changes violate their contractual benefits rights and case law under Bakenhus.

What is Bakenhus?
In the 1956 Bakenhus decision, the State Supreme Court ruled that pension benefits are a vested contractual right, and cannot be changed or reduced retroactively without providing a similar benefit of equal value. This means that any change that potentially reduces benefits could be challenged in court.

What is gain-sharing?
Gain-sharing was adopted by the legislature in 1998 for PERS 1 and PERS 3, and for plans covering teachers and school employees. The basic premise was to share significant pension investment gains (“extraordinary gains”) with retirees through increased benefits. Under gain-sharing, if the average rate of investment returns on the pension funds over the previous four years exceeded 10%, then half of the earnings would be used to increase benefits and half would be used to accelerate the amortization of the PERS and TRS plan 1 unfunded liability costs.

The law included the ability to repeal gain-sharing at a future time. This was intended to protect the State and PERS system from unintended impacts in the future. It was also intended to serve as protection against Bakenhus claims, and the prohibition against retroactive changes to a contractual right.

The Legislature repealed gain-sharing in 2007 (HB 2391) as a result of an actuarial analysis that showed significant long-term increases to pension costs. The State Actuary determined that the future cost of gain-sharing distributions would result in an effective reduction in the long-term average rate of return that can be assumed from the pension funds. The long-term average would be lowered through the gain-sharing mechanism because in some periods of very good investment returns, some extraordinary gains are distributed as additional benefits. The Actuary determined that higher contribution rates would be required to fund the future gain-sharing distributions.

The Legislature relied on the ability to repeal when they ended the program in 2007. However, in recognition of the potential legal challenges, the Legislature opted to “repeal and replace” instead of a straight repeal of the program. The 2007 changes repealed gain-sharing, and replaced it with alternative benefits including an increased COLA for Plan 1 members, and early retirement options for members of Plans 2 and 3.

What is the PERS 1 Unfunded Liability?
The PERS 1 pension program was closed to any new members in 1977. Employers and employees contribute 6% of salary to the system. However, the PERS 1 system is only funded at 69%, meaning it has insufficient funds to meet the expected payments due retirees. As a result, employers also pay a PERS 1 unfunded liability surcharge on top of PERS 2 and PERS 3 the pension contribution rates.

What about the elimination of Uniform COLA for PERS 1?
In response to fiscal pressures from the Great Recession and concerns about sustainability of the pension programs, in 2011 the legislature ended a long-standing practice of automatic Uniform COLA increases for PERS 1 retirees by adopting HB 2021.

The Uniform COLA was established by the Legislature in 1995. It is a fixed dollar amount multiplied by the member’s total years of service. The dollar amount of the Uniform COLA was $1.86 in 2010, and increased by 3 percent every year on July 1. When it was created in 1995, the Legislature specified that members do not have a contractual right to future increases to the Uniform COLA. This change reduced the unfunded liability in the PERS 1 plan from 5.25 percent to 3.5 percent.

The State Actuary predicted that this change would save local government employers $491 million in 2013-2015 and $3.3 billion over 25 years (2011-2036). The state was expected to save $4.3 billion during the same 25 year period.

This change was almost immediately challenged by retirees, and in 2012 there was a Superior Court ruling that the state had acted illegally in ending the benefit. However, the case has been appealed and now is in the hands of the State Supreme Court.

What will the Court’s decision mean?
Should the Court uphold the changes made to the pension system, it will be an important legal decision clarifying the ability of the state to reserve the right to make changes to pension benefits.

However, if the Court finds that the changes made were not legal, there will be a significant fiscal impact for public employers in increased pension rates. If the Court reinstates the Uniform COLA, it is estimated to cost local governments $3.3 billion over 25 years in increased pension rates and the state $4.3 billion over 25 years. If the Court reinstates gain-sharing, it is estimated to cost local governments $1.7 billion over 25 years in increased pension rates and the state $1.6 billion.

We will continue to follow this issue and provide additional information as it becomes available.

Here are some links to additional documents that may be helpful in understanding these issues.

WSAMA & AWC Amicus Curiae - Gain-Sharing
WSAMA & AWC Amicus Curiae - UCOLA
Select Committee on Pension Policy - Gain-Sharing Study 2005

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