Washington State Department of
Labor & Industries

Pension Discount Rate: Need for Legislative Change

December 2017

Brief summary

The current pension discount rate is higher than actual earnings, but changing the rate abruptly would require a large lump-sum payment from both the state fund and self-insured employers to make up the difference. The Department has worked to determine whether a need exists to set separate pension discount rates for state fund and self-insured pensions. This overview explains the mechanics of the problem and proposes changing current law to allow the Department to set two pension discount rates: one for the state fund pension liabilities and another for pensions managed on behalf of self-insured employers. Bill language to make this change is attached.

Background

L&I pays pensions to those workers who are totally and permanently disabled, or to beneficiaries of workers who have died, as a result of an industrial injury or occupational disease. Pensions are paid out of the pension reserve fund; the Department transfers funds from the accident fund or appropriate account to the pension reserve fund.

Self-insurance is an option for some employers, usually large employers, who have the financial means to meet workers' compensation obligations for their own employees. L&I administers pensions for self-insured employers: L&I pays pensions to disabled workers (or beneficiaries) and the self-insured employer pays into the pension reserve fund.[1]

Issue

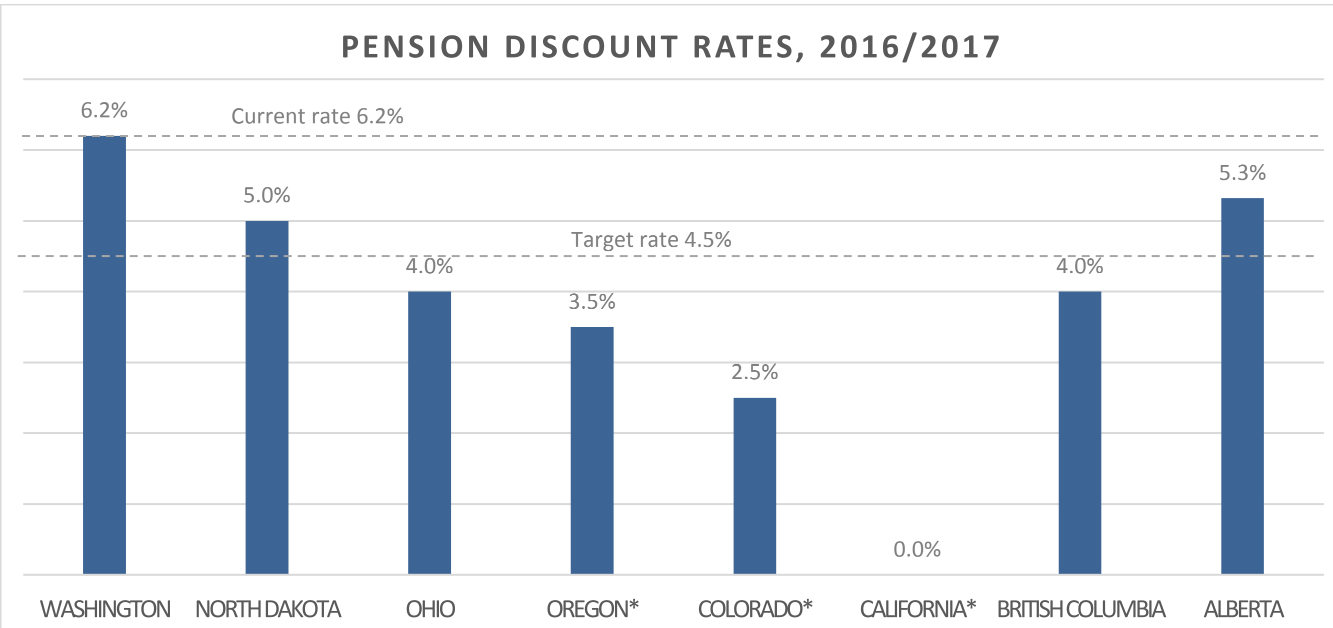
Under current law, the amounts paid into the pension reserve fund by the state fund or by self-insured employers must be calculated "in the same manner" (RCW 51.44.070 (1)). In accordance with that statute, the Department's actuaries calculate the pension reserves by estimating the total amount that the Department will pay over the life of each benefit, which is expected to extend 10, 20, 30 or more years into the future. One factor in calculating that amount is the expected earnings from interest. The department sets that expected earnings rate, known as the pension discount rate, in WAC 296-14-8810; it is currently 6.2 per cent. When the actual interest earned does not meet that projection, money must be transferred from the state fund (RCW 51.44.80) and paid by each self-insured employer (RCW 51.44.140) to make up the deficit.

Interest rates across the economy have decreased significantly and the discount rate does not reflect the current reality. The Department has begun gradually reducing the rate over the past two years in accordance with recommendations from the Workers' Compensation Advisory Committee. The target discount rate is 4.5 per cent, consistent with the projected investment earnings, per the State Investment Board. For comparison, the graph below compares Washington's current pension discount rate with those in other states. According to a recent

[1] Self-insured employers may alternatively choose to file with the department a bond, assignment of account, or purchased annuity with sufficient funds to insure pension benefit payment.

study by A.M. Best, the average yield on invested assets of state funds has been declining steadily, falling to 3.1% in 2015 from a high of 4.6% in 2008.[2]

The Department could adjust the rate at any time and transfer the appropriate amount to the reserve fund to make up the difference, and it has other methods at its disposal to spread those costs out over time. However, if it did so, the self-insured employer group would face a sudden, one-time, lump-sum charge to fill the deficit, and they would need to pay immediately (RCW 51.44.140). As of June 30, 2016, that amount would be approximately $156 million. By contrast, for current liabilities, self-insured employers would pay a lump sum of between $16 and 20 million for each quarter-point change in the rate (i.e. from 6.00% to 5.75%) if the rate were adjusted more gradually. For each year that the discount rate is still higher than actual earnings accrued,[3] they would also continue to pay yearly adjustment payments.



*Note: All pension discount rates are from the state's or province's 2016 Annual Report, with the exception of Washington's, which is the 2017 pension discount rate. *Oregon, Colorado and California have competitive markets.*

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[2] A.M. Best, 2015, *Best's Special Report: U.S. State Compensation Funds*, page 6.
[3] Deloitte Consulting's most recent audit report notes that the long-term yield on risk-free assets, i.e. U.S. Treasury bonds, matching the duration of the Department's average pension liability was 2.51%, as of June 30, 2017.