Trends and Threats Facing Public Pension Systems

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Objectives

- Discuss national trends in public employee retirement systems
- Provide information about recent significant plan changes
- Identify potential threats facing public employee retirement systems
- Briefly discuss some recent studies and findings
National Trends
Where Are We Now?

- Sharp investment declines (but also rebounds) coupled with improvements in mortality
- Falling funded ratios
- Increasing contribution rates
- Increasing fiscal pressures on plan sponsors
- Political antagonism toward public plans
State and Local Government Retirement Funds by Major Investment Type (1982 - 2011:Q1)

Source: Board of Governors of the Federal Reserve, Flow of Funds, annual.
Several states have recently lowered their long-term rate of return assumption.

Many more are currently considering it.

<table>
<thead>
<tr>
<th>Plan</th>
<th>Prior</th>
<th>New</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Virginia</td>
<td>7.50%</td>
<td>7.00%</td>
<td>-0.50%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>8.00%</td>
<td>7.50%</td>
<td>-0.50%</td>
</tr>
<tr>
<td>Colorado</td>
<td>8.50%</td>
<td>8.00%</td>
<td>-0.50%</td>
</tr>
<tr>
<td>California STRS</td>
<td>8.00%</td>
<td>7.75%</td>
<td>-0.25%</td>
</tr>
<tr>
<td>New York</td>
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<td>Illinois</td>
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<td>7.75%</td>
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</tr>
</tbody>
</table>
Life Expectancy in Years, Current Age 65

National Vital Statistics Reports, Vol 59, No 4, March 2011
Declining Funded Ratios

Public Pension Funded Ratios

FY 2010 data based on updated information presented at 2011 NASRA Annual Conference.
Increasing Contributions

State & Local Government Contributions for Retirement Benefits
As a Percent of General Revenues, Operating Expenditures, and Salaries & Wages (1982 - 2008)

Source: U.S. Census Bureau, State and Local Government Finances, annual. Percentages calculated by author.
Contribution Experience

Annual Required Contribution Experience

FY 2010 data based on updated information presented at 2011 NASRA Annual Conference.
How Did We Get Here?

- **External factors:**
  - Financial market declines
  - Rising unemployment
  - Economic decline
  - Falling housing values
  - Falling state and local revenues

- **Internal factors:**
  - Benefit increases in late 1990s
  - Investment risks
  - Employers contributing less than the ARC
Accumulated Value of a Portfolio Consisting of 60/40 Stocks and Bonds Compared with Long-Term Government Bonds

- **60S/40CB**
- **LTG Bonds**
Unemployment Rates

U.S. Unemployment Rate 1990 - 2011 (January Rates)

Rates of Change in Key Economic Variables

(Seasonally adjusted annual rates deflated using the implicit price deflator for personal consumption expenditures)
Falling Local Revenues

- National League of Cities survey of city fiscal conditions projects:
  - In 2010, city general fund revenues were down -3.2% while expenditures were -2.3%.
  - To cover budget shortfalls, cities will freeze or reduce personnel, delay infrastructure projects, and reduce services.
Where are We Going?

- Benefit changes – largely for new hires
- Changing GASB standards
- Proposed federal disclosures of public pension funding status
Benefit Changes
Benefit Changes

- According to the National Conference of State Legislatures, 27 state legislatures enacted significant retirement system changes in 2011 (21 in 2010).
- Since some states revisited the topic, in all, 40 states enacted significant retirement legislation in 2010 or 2011.
- Key benefit changes in 2011 include:
  - Higher employee contributions as a percent of salary
  - Reduced benefits for new employees
  - Some changes to COLAs
## 2011 State Retirement Legislation

<table>
<thead>
<tr>
<th>Type of Benefit Change</th>
<th>Number of States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased Employee Contributions</td>
<td>16</td>
</tr>
<tr>
<td>Increased Vesting Requirements</td>
<td>7</td>
</tr>
<tr>
<td>Increased Age/Service Requirements for Normal Retirement</td>
<td>15</td>
</tr>
<tr>
<td>Extended Period for Final Average Salary</td>
<td>6</td>
</tr>
<tr>
<td>Reduced Post-Retirement Benefit Increases</td>
<td>10</td>
</tr>
</tbody>
</table>

16 states increased employee contributions in 2011 (11 in 2010).

In 12 states, the increases applied to current employees. In 4 cases the increases applied to new employees.

In 8 states, the increased employee contributions offset (in whole or in part) employer contributions.

Many increased the employee contribution rate by 2 or 3 percentage points, spread over two or more years.

In 3 states, the increases were temporary, with the expectation that contributions would be lowered in the future.
15 states increased their age and service requirements for normal retirement.

Generally, the increases applied to people hired after the legislation’s effective date (and to non-vested employees in a few states).

The changes move retirement age closer to age 65 and often increase required service (e.g., age/service combinations like 62/5 were changed to 65/10).

Many also increased the reduction factor for early retirement benefits (e.g., reduction factor of 0.2% per month prior to age 60 increased to 0.4% per month).
Vesting Periods

- 7 states increased vesting periods (5 in 2010).
- Generally the changes were from 3 to 5 years or from 5 or 6 years to 8 or 10 years.
6 states increased the averaging period for final average compensation (8 in 2010).

In most cases, the change was from highest 3 years to highest 5 years.

In all cases, this was applied to people hired after the effective date of the legislation.

Several states restricted final average compensation by limiting overtime or bonus payments or specifying certain averaging methods.

New Hampshire limited retirement benefits to the lower of 85% of final average compensation or $120,000. The $120,000 limit was in existing law.
4 states changed benefit multipliers

- Hawaii reduced the multiplier for new employees from 2.00% to 1.75%
- Maryland reduced the multiplier for new employees to 1.5% (formerly 1.8%)
- Mississippi changed its formula from:
  - 2% for the first 25 years of service and 2.5% thereafter
to
  - 2% for the first 30 years of service and 2.5% thereafter
Postemployment COLAs

- 10 states revised their automatic post-retirement COLAs (8 in 2010).
- In 3 states, the changes affect current benefit recipients.
- In all cases, the legislation reduced future COLAs.
- In Oklahoma, the change required future COLAs to be funded at time of enactment.
Postemployment COLAs

- In Arizona, the COLA is constrained by the funded ratio:
  - 2% if the funded ratio is at least 60% growing incrementally to 4% if the funded ratio is at least 80%.
- In addition, the COLA must be funded by investment earnings in excess of 10.5% in the year before the year the COLA is given.
- If the earnings in excess of 10.5% are not sufficient to fund the COLA, the increase is limited to only the amount that can be funded.
- Any excess over the amount needed to fund the COLA in a given year are not available for future years.
“Two Part Hybrid”

- Retirement benefits are provided by half DB and half DC.
- 8 states now offer a two part hybrid: IN, WA, OH, OR, GA, MI (public schools), UT
- …and now Rhode Island.
- The Rhode Island Retirement Security Act makes broad changes to all plans effective July 1, 2012.
Some states like Texas and Nebraska have successfully managed the cash balance arrangement in proving retirement benefits.

In 2011, 4 states considered a move to a cash balance plan, but did not implement:

- Kansas
- Maryland
- Montana
- Pennsylvania
Potential Issues and Threats
In 2011, GASB released its Exposure Drafts of potential changes to public pension accounting and reporting:

- Accounting and funding would be decoupled.
- The unfunded pension liability (or “net pension liability”) would be included on the employer’s financial statement rather than solely in the supplemental information.
Potential implications of changing the standards include:

- Creation of separate accounting and funding measures may cause additional confusion about the “real” costs and funded status of a public pension plan.

- The net pension liability will likely be more volatile than the unfunded actuarial accrued liability that is currently disclosed.

- The EDs, if adopted, would likely increase the size of pension liabilities and expense reported in the employer’s financial statement.
In February 2011, the Public Employees Pension Transparency Act (PEPTA) was reintroduced by Reps. Devin Nunes (R-CA), and supported by Paul Ryan (R-WI) and Darrel Issa (R-CA).

It would require sponsors of State and local government employee pension plans to report funding information annually to the Secretary of the Treasury. Governments failing to report this information would lose their ability to issue tax-exempt debt until they comply.

The legislation would not alter existing funding standards for State and local plans or require Federal funding standards.

It would prohibit the federal government from accepting any current or future obligations of State and local pension plans.
Proposed Federal Disclosures (cont.)

Proposed annual reporting requirements:

A. Schedule of funding status – including “current liability,” assets, and plan’s funding percentage;
B. Schedule of contributions by the plan sponsor;
C. Alternative projections of annual contributions, fair market value of assets, current liability over next 20 years;
D. Statement of actuarial assumptions;
E. Statement of plan participants;
F. Statement of plan investment returns – including actual rate of return for past 5 years;
G. Statement of “degree and manner in which the plan sponsor expects to eliminate any unfunded current liability;” and
H. Statement of outstanding pension obligation bonds.
Additionally, the following would have to be remeasured if the annual report does not measure assets at fair value or if liabilities are not discounted using U.S. Treasury bond yields:

- Schedule of funding status;
- Alternative projections;
- Statement of plan investment returns; and
- Degree and manner plan sponsor expects to eliminate current unfunded liability.

This would result in yet another set of measures that are different from those used to fund the plan or are used for accounting and financial reporting purposes.

Overall these measures would be very different from current measures of public plans’ funded status.
Results of some recent studies
In May 2011, the Center for Retirement Research at Boston College (CRR) released its report on “The Funding of State and Local Pensions in 2010” based on sample of 126 state and local plans.

Key findings include:

- Overall funded status was 77%, with $2.7 trillion in actuarial assets and $3.5 trillion in total liabilities.
- The slight decline in funded status from 79% in 2009 to 77% in 2010 was due to moderate increases in liabilities while actuarial assets grew more slowly (due partly to asset smoothing).
Key findings continued:

- Financial crisis resulted in higher unfunded liabilities increasing the amortization component of the annual required contribution.
- The average ARC increased from 11.8% in 2008 to 12.7% in 2009 and 13.5% in 2010.
- The higher ARC and substantial decline in state and local tax revenues resulted in falling employer contributions as a percent of the ARC.
- Employer contributions ARC fell from an average of 92% of the ARC in 2008 to 84% in 2009 and 78% in 2010.
- Many states are working to improve funding by reducing payroll, decreasing benefits for new hires, and increasing employer and employee contributions.

Link: [http://crr.bc.edu/images/stories/slp_17_508.pdf](http://crr.bc.edu/images/stories/slp_17_508.pdf)
In May 2011, the GFOA Executive Board approved a new Best Practice on *Designing and Implementing Sustainable Pension Benefit Tiers*.

For jurisdictions considering new benefit tiers, GFOA recommends:

► Examining the government’s authority to revise its pension benefits;
► Identifying the overall goals in doing so;
► Understanding the effects of the change on the workforce;
► Determining the financial impacts of the change on the government and its employees;
► Soliciting input from actuaries regarding forecasting benefit costs and determining funding adequacy; and
► Understanding key plan design elements.
With regard to plan design changes, the BP suggests considering:

- Recalibrating normal and early retirement ages;
- Reviewing benefit multipliers in light of all income expected in retirement, including Social Security, Medicare, and personal savings;
- Providing COLAs that are actuarially funded and financially sound;
- Clearly stating new tier benefits enhancements will be prospective only;
- Basing service credit purchases on actuarial cost;
- Excluding extraordinary income from final average compensation;
- Providing ample time and sufficient notice for employees to adapt to the changes.

In March 2011, the Employee Benefit Research Institute (EBRI) released its issue brief titled, The 2011 Retirement Confidence Survey: Confidence Drops to Record Lows, Reflecting “the New Normal.”

Key findings include:

- 27% of active workers are “not at all confident” about having enough money for a comfortable retirement, the highest level ever measured by the survey (up from 22% in 2010).
- 13% workers are “very confident” about having a financially secure retirement (down from 16% in 2010).
- The expected retirement age of workers remains relatively unchanged from 2010. However, the percent of workers who expect to retire after age 65 has increased from 11% in 1991 to 20% in 2001 to 36% in 2011.
- 74% of workers expect to work for pay in retirement (up from 70% in 2010). This is three times higher than the percent who reported they actually worked for pay in retirement.
Conclusion

How Do We Get Where We Want to Go?

► Design sufficient and sustainable benefits
► Establish sound funding policy
► Make reasonable valuation assumptions
► Make required contributions
► Avoid basing benefits on “excess assets”
► Mitigate investment and other risks
Questions and Comments?
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