PENSION TRUSTEE ADVISORS

Rethinking Public Pension Plan Design

Wisconsin School of Business

2011 Pension Conference

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Today we'll discuss:

- Quick background on public pensions
- Overview of current situation
- How we arrived at current situation
- Potential changes to public pensions
  - Employer Cost and Risk
  - Benefit Adequacy

Public Pension Background

- Pensions Created to Facilitate Orderly Retirement
- Most Public Plans are Defined Benefit
  - The lifetime pension amount is defined in statute
  - The contributions depend on actuary's calculations
- Most Private Plans are Defined Contribution
  - The workers know what's going into the fund
  - But they don't know what they'll be able to pay themselves
- Many Public Plans pre-date Social Security
  - Many Public Employees are not Covered

Where are we? – May Headlines

Center on Budget and Policy Priorities

"Fortunately, pension contributions … represent a modest share of state budgets, typically between 2 percent and 5 percent of state and local spending, averaging 3.8 percent." [WI is 3.6%]

Los Angeles Times

"…the overall costs of public pensions are poised to crush state and local services."

THE WALL STREET JOURNAL.

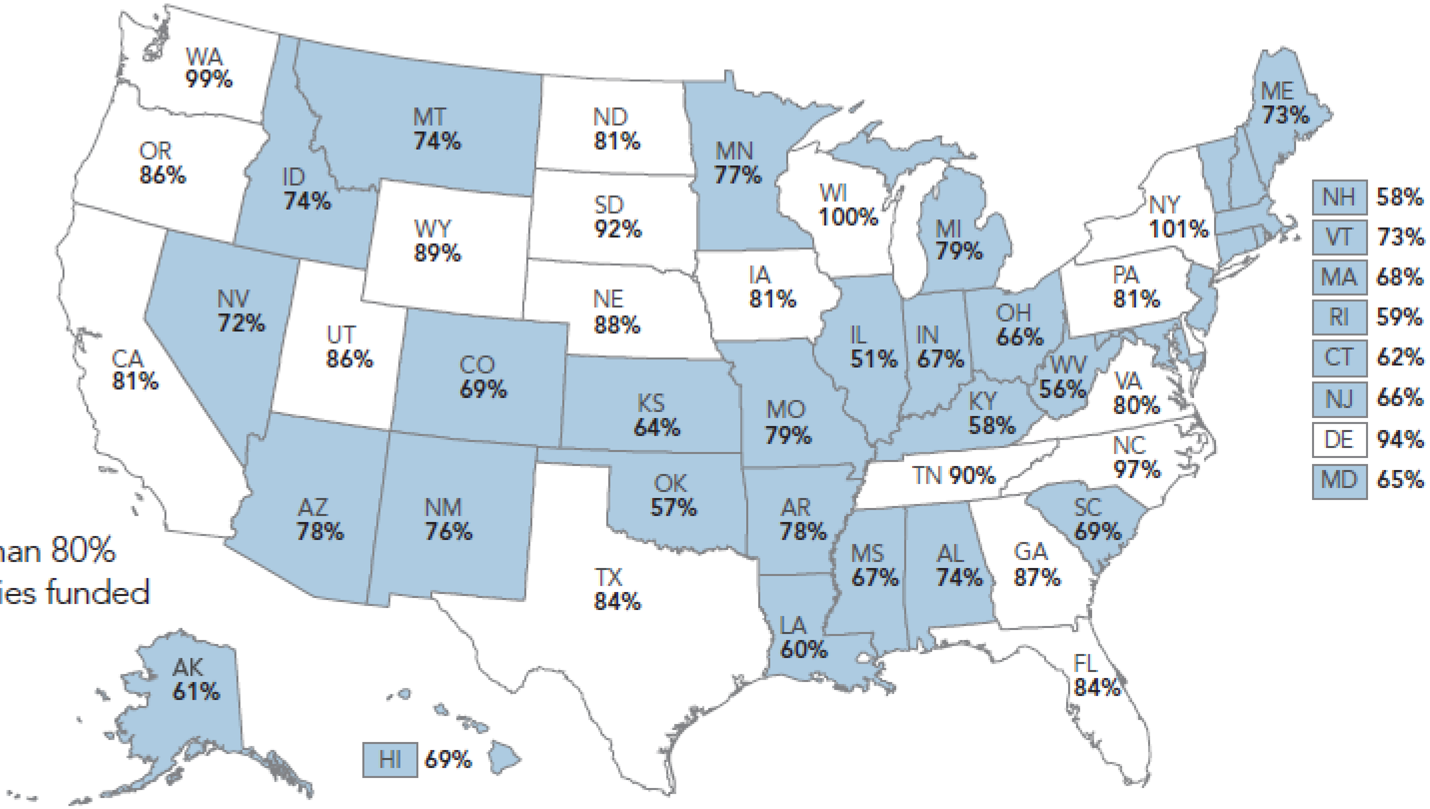
"The rapid deterioration of state finances must be addressed immediately."

Where are we?

- "The trillion dollar gap – Underfunded state retirement systems and the roads to reform" – February 2010
- State pension plans rated by PEW
  - 16 states – solid performers (including **WI**, NY, FL)
  - 15 states – need improvement (includes IA, MI, MN, CA, TX)
  - 19 states – serious concerns (includes IL)

PEW Reports State's Public Sector Pensions 78% Funded in FY 09

Thirty-one states were below the 80 percent funded threshold for a well-funded pension system.



States with less than 80% of pension liabilities funded

Source: PEW 2011

Where else are we?

- WSJ reported that average 60-62 household has less than 25% of what's needed for retirement
- Boston College Center for Retirement Research (CRR) estimates 78% aggregate funding level for public plans
- 78% is a lot better than 25%
    - The two numbers really are analogous: what you've got vs. what you should have
    - CRR estimates about $0.5 trillion "unfunded liability" for public pensions
    - Retirement USA estimates $6.6 trillion gap for private retirement
    - Delayed retirement will have profound economic impact

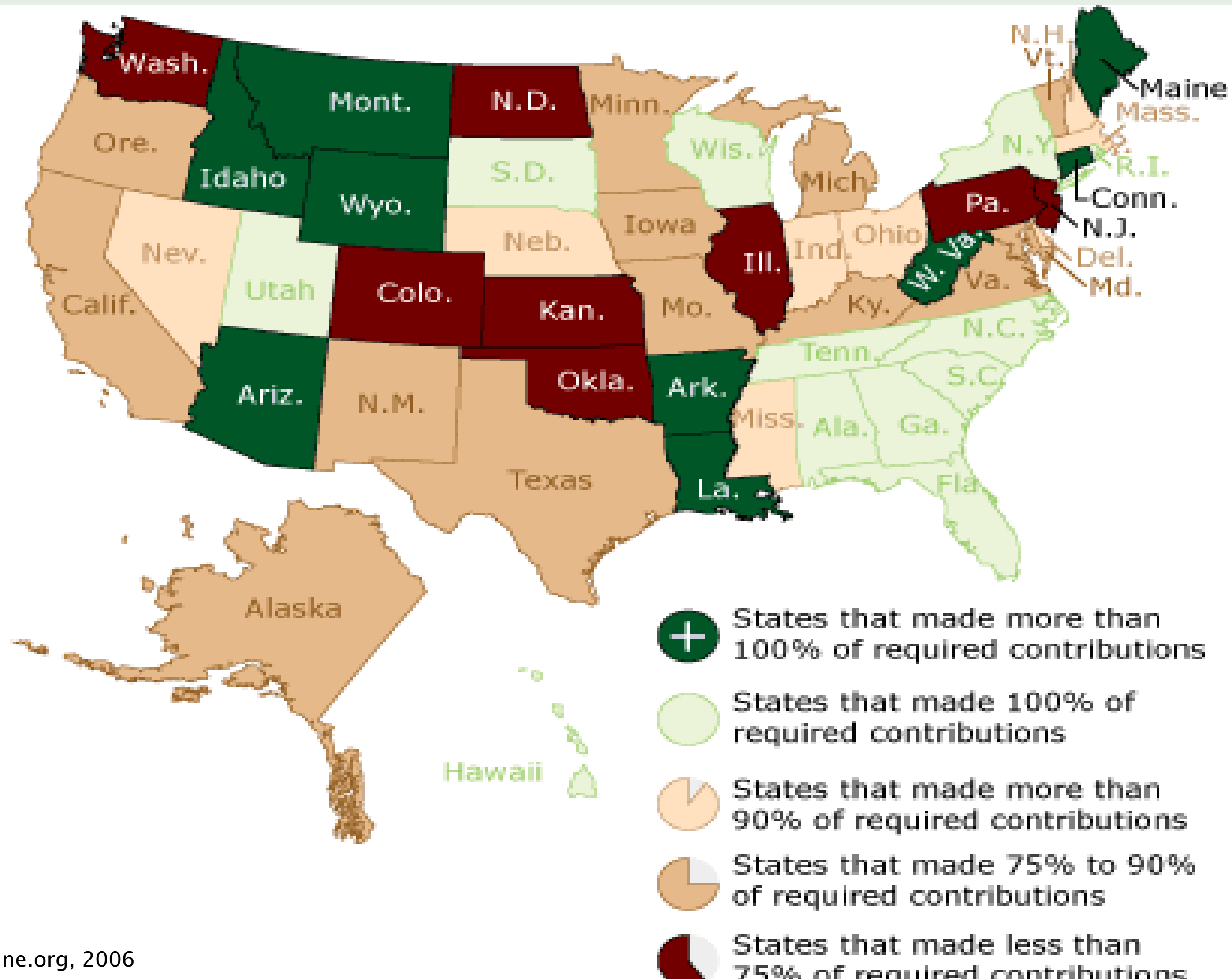
How did we get here – Private Sector?

- NIRS reports that DB plans have been closing because:
  - Increased regulation hurts the cash-flow of company sponsors
  - Private-sector industry changes result in fewer unionized jobs and new industries without DB legacy & more turnover
  - Popularity of 401(k) during high-return 1990's
- Companies loved lower costs of 401(k), but they provide still lower benefits because:
  - Professionally managed DB plans have higher returns than individually managed DC plans
  - Individuals don't know how long they'll live, so can't withdraw appropriately
  - Individuals need to become more conservative investors as they age, resulting in lower returns

How did we get here – Public Sector?

- Market collapse
  - Assumed rates of return of 7-8%
  - Actual average 2 year loss of 24%
- Failure to adequately fund plan costs

ARC Funding



From PEW, Stateline.org, 2006

How did we get here? (continued)

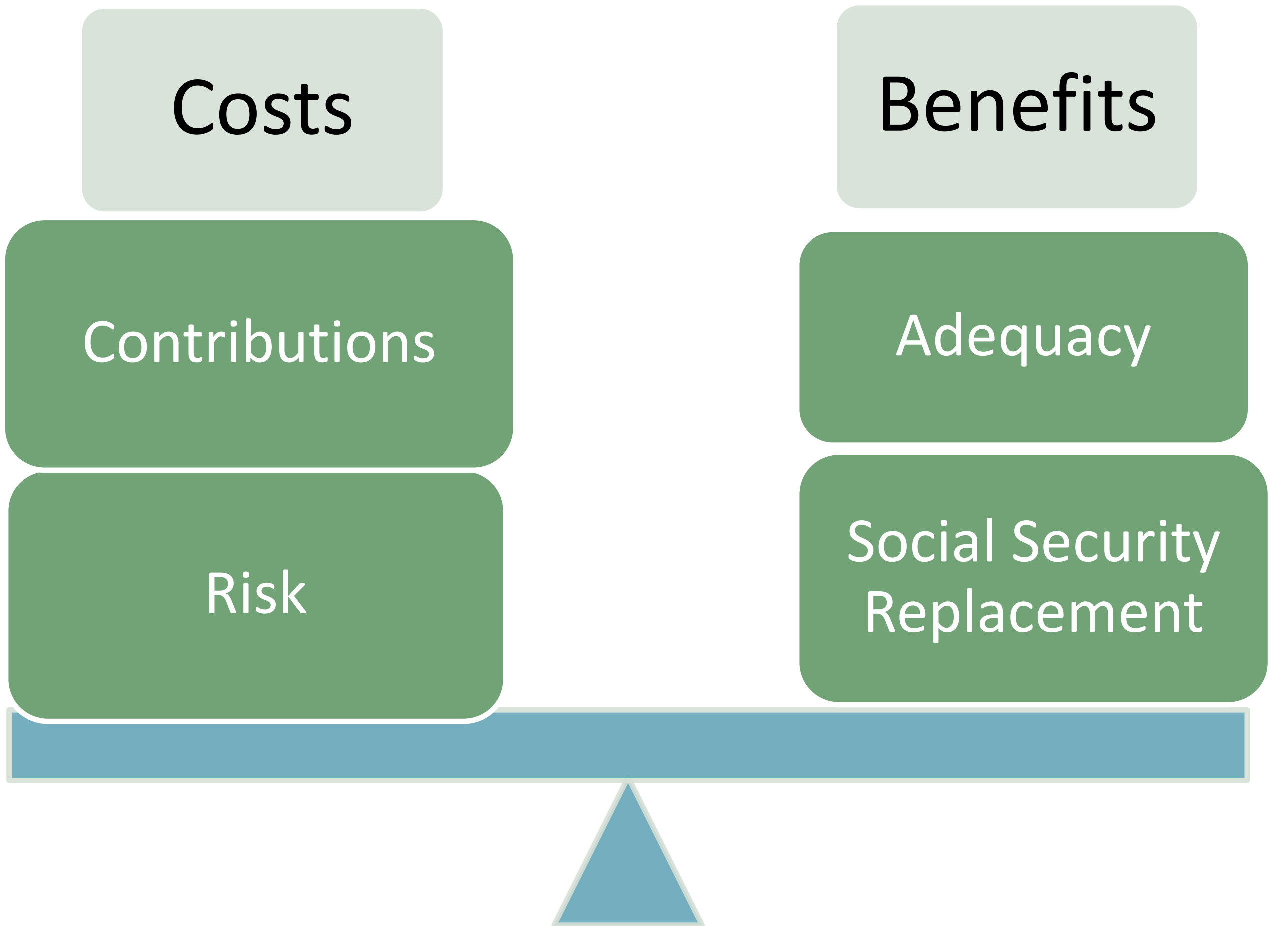
- Some high profile “abuses”
  - Pension spiking
  - Double dipping
  - Disability approvals
- Policy decisions with long-term impacts
  - Some benefit increases when plans were “overfunded”
  - Some contribution holidays when plans were “overfunded”
- Difficult to reverse these
  - Public pension plans are commonly protected by statute, state constitution, or contract or property laws
  - Governments don’t want to increase contributions

Center on Budget and Policy Priorities

Recommended Solutions

- Act now to craft plan to restore solvency gradually.
- Move carefully to change, as necessary, methods for determining needed contributions.
- Immediately change rules to reduce abuses such as “double-dipping” and “spiking”.
- Gradually move to boost contributions by governments and/or employees and modestly scale back benefits.
- Continue to offer defined-benefit plans.

It’s a matter of balance



This is Analogous to Equation:

$$C+I = B+E$$

Contributions + Investment Income

= Benefits + Expenses

PTA Recommended Solutions

- Analyze C+I Side of Equation
  - Consider Expected Employer Cost
  - Consider Risk of Increased Costs
  - Consider Likelihood of Insolvency
  - Consider Investment Returns, But Must Include Risk
- Analyze B+E Side of Equation
  - Need to Provide Adequate Benefits
  - Define a Full Career
  - Consider Employee Contributions
  - Of Course Expenses are Important, but Impact is Low

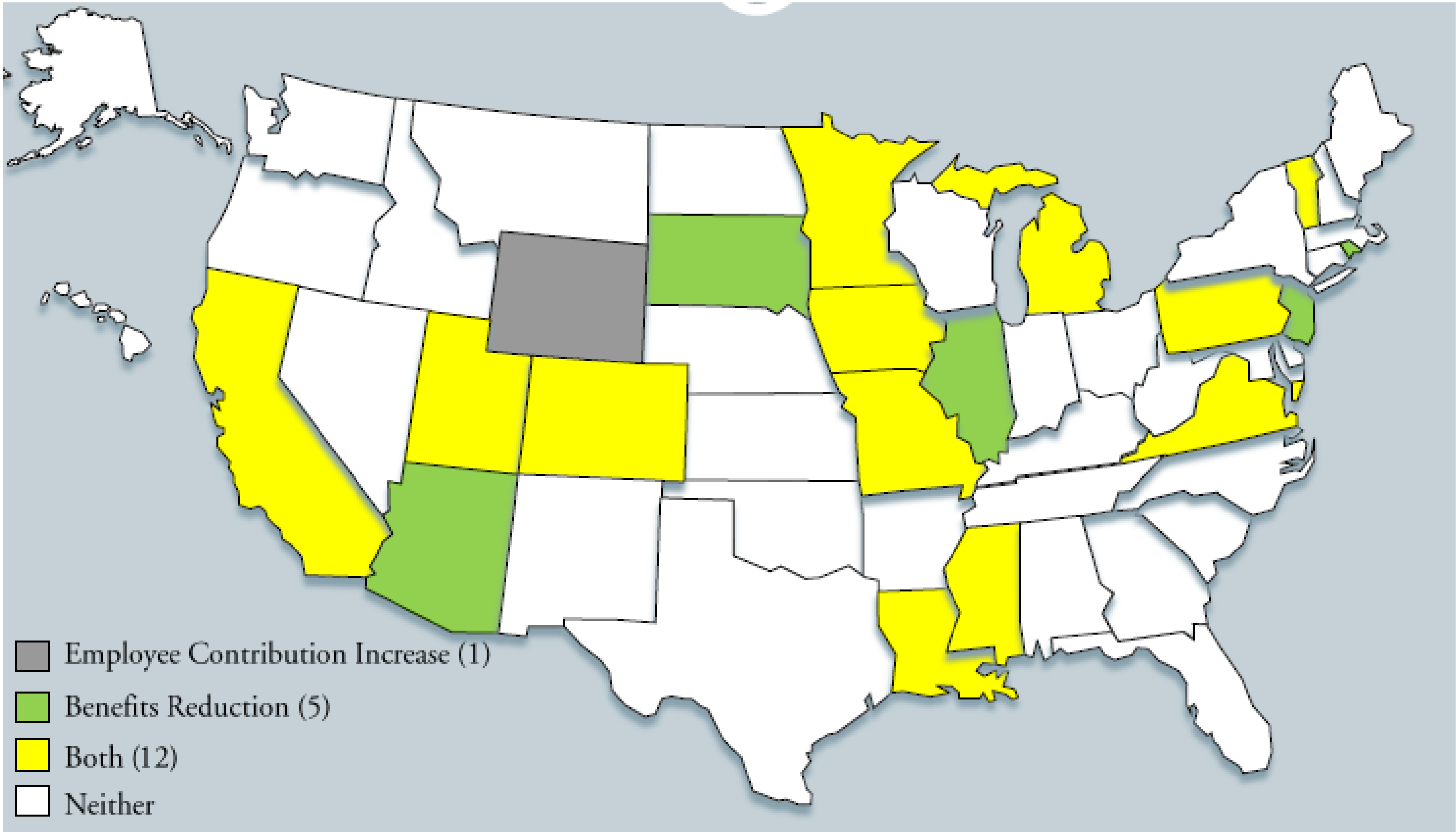
What about defined contribution?

- NIRS 2008 Paper “Better Bang for the Buck”
  - Co-authored by Beth Almeida and William Fornia
  - DB plans cost about half
- Reasons for Defined Benefit Plan Efficiency
  - Retirees can’t predict their own life expectancy; pooled DB plans can, but DC retirees must over-save
  - Individuals must invest more conservatively as their time horizon shrinks; pooled DB plans’ horizons stay long
  - Pros are better investors than individuals; higher returns

Plan design changes being considered

- Increase normal retirement age
  - Remove “service only” requirements
  - Increase age to match Social Security
- Final Average Salary
  - Extend average period of time (i.e., from 3 years to 5 years)
- DB/DC plan design
  - Some have considered shift to DC
    - Does not solve underfunding
  - State of Utah new design (caps future state contributions)

Pension Changes are Becoming More Commonplace

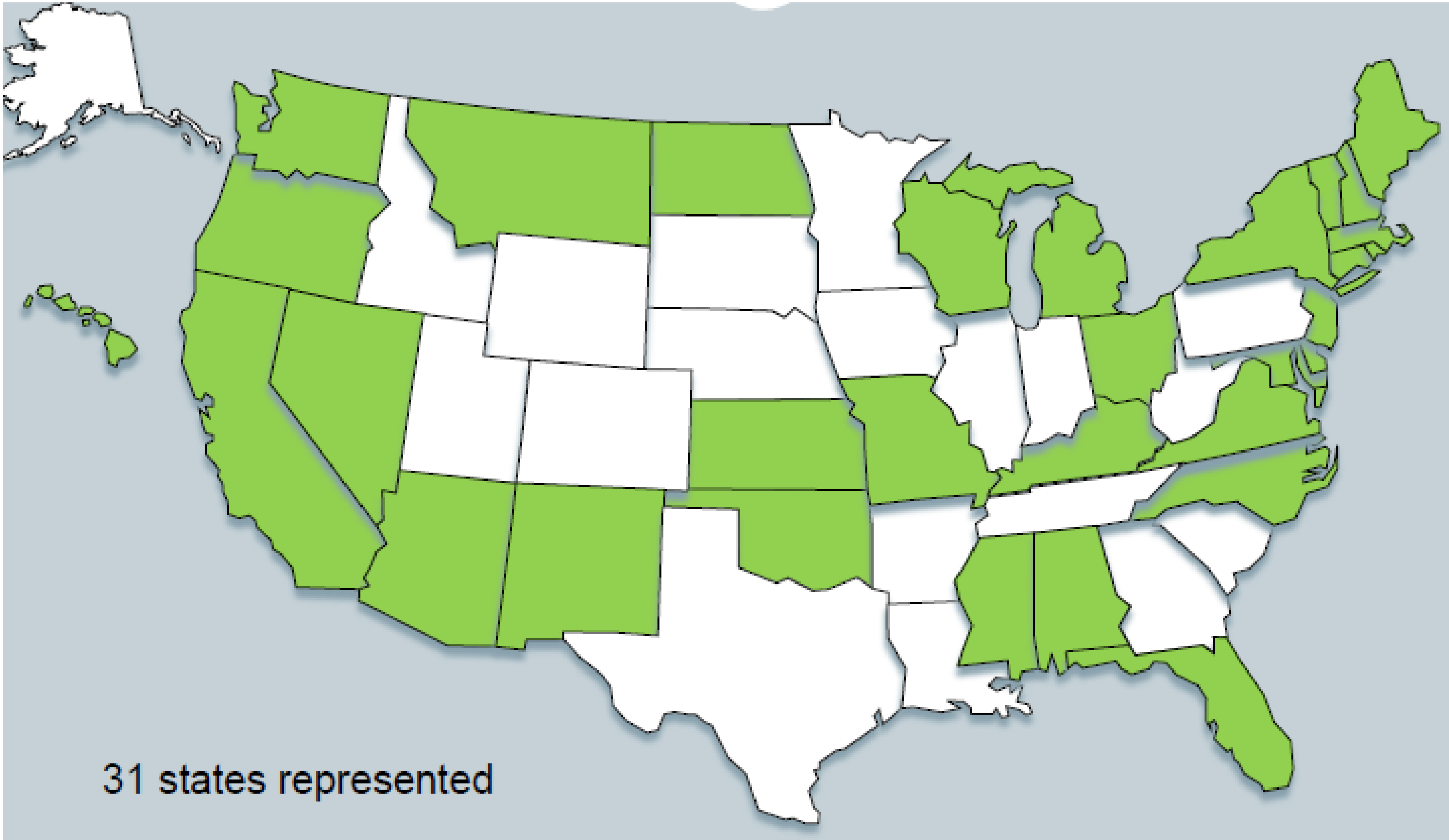


Source: National Conference of State Legislatures - 2010

NCSL reported that 8 states reduced their Cost of Living Adjustments in 2010

- Including those already retired:
  - Colorado
  - Minnesota
  - South Dakota
- Including those already hired: Rhode Island
- Future Hires Only:
  - Illinois
  - Michigan
  - Utah
  - Virginia

Most states considering major 2011 legislation



Source: National Conference of State Legislatures - 2011

Statewide Mandatory DC/ Hybrids

- Utah 2010 Hybrid Program
- Michigan 2010 School Employees DB+DC
- Georgia 2009 Combination DB+DC
- West Virginia 2005 Reopened DB
- Oregon 2003 DB+DC
- Nebraska 2002 Hybrid (switch from DC)
- Michigan State Workers 1997 DC
- Washington 1995 DB+DC
- District of Columbia 1987 DC
- Texas MRS & CDRS longstanding Hybrid
- Indiana long standing Hybrid

Examples of Activity Proposed

- Center for Retirement Research Proposes “Stacked Plans”
- Kansas governor expected to sign law requiring increased contributions & commission to consider DC
- Oklahoma bill to require COLA’s be funded
- New Jersey governor proposed delayed retirement age
- Atlanta mayor proposing DC, including hard freeze for actives
- Puerto Rico proposed cuts to DB & restructure
- Maryland proposing increased contributions & other changes
- Alaska bill to restore DB plan

Employer Contributions Vary:

- Some employers are required to fund at actuarially calculated rate
- Some systems periodically recommend increased statutory contribution rate
- Some governments ignore actuary's and system's recommendations
- Many variations of above three approaches

Nearly all Employers are Increasing Contributions - Examples

- Illinois borrowed $3.7 billion to cover most of State's scheduled pension payments this year
- Florida legislature cuts workers pay 3% to fund pensions
- New York City 19% increase
- Rhode Island Retirement Board to Recommend Increase
- CalPERS Contribution Increases:
  - Some Employee Contributions increasing 2% to 5%
  - Employer Contributions also increasing
  - Governor Brown proposing to reduce pension costs
- … But Federal Government is using pensions to avoid exceeding debt ceiling

NCSL reported that the following states increased employee contributions in 2010

- Including for currently active employees:
  - Colorado
  - Iowa
  - Minnesota
  - Mississippi
  - Vermont
  - Wyoming
- For future hires only:
  - Louisiana
  - Missouri
  - Pennsylvania (optional)
  - Utah
  - Virginia

Other concerns with respect to public pensions

- Severe State budget problems
- NYT: “Public Workers Facing Outrage as Budget Crisis Grows”
- Lower discount rates supported by some economists increase unfunded liabilities ($3.5 vs. $1 billion)
- Government Accounting Standards Board tighter rules anticipated
- Severe underfunding in some states (IL, NJ)
- Public Employee Pension Transparency Act
- Bankruptcy concerns
- Generally agreed that problems can’t be solved purely with investment returns

Conclusions

- Private sector retirement gap is a much bigger problem than public sector funding gap
- Plan funding has weakened
- Government budgets are tight
- Pensions are being changed
- Changes should consider
  - Contributions, risk and solvency
  - Adequate benefits for full career
  - DB is more economical than DC

Questions?

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