A Comprehensive Proposal for Reforming Pennsylvania's Unsustainable Retirement Systems

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Managing Pension Liabilities

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The Public Pension Crisis

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"… the fundamental problem is that public pensions are inherently political institutions."

"… the current public pension system simply isn't sustainable in the long run."

Three Factors Drive the Political Institution of Public Pensions

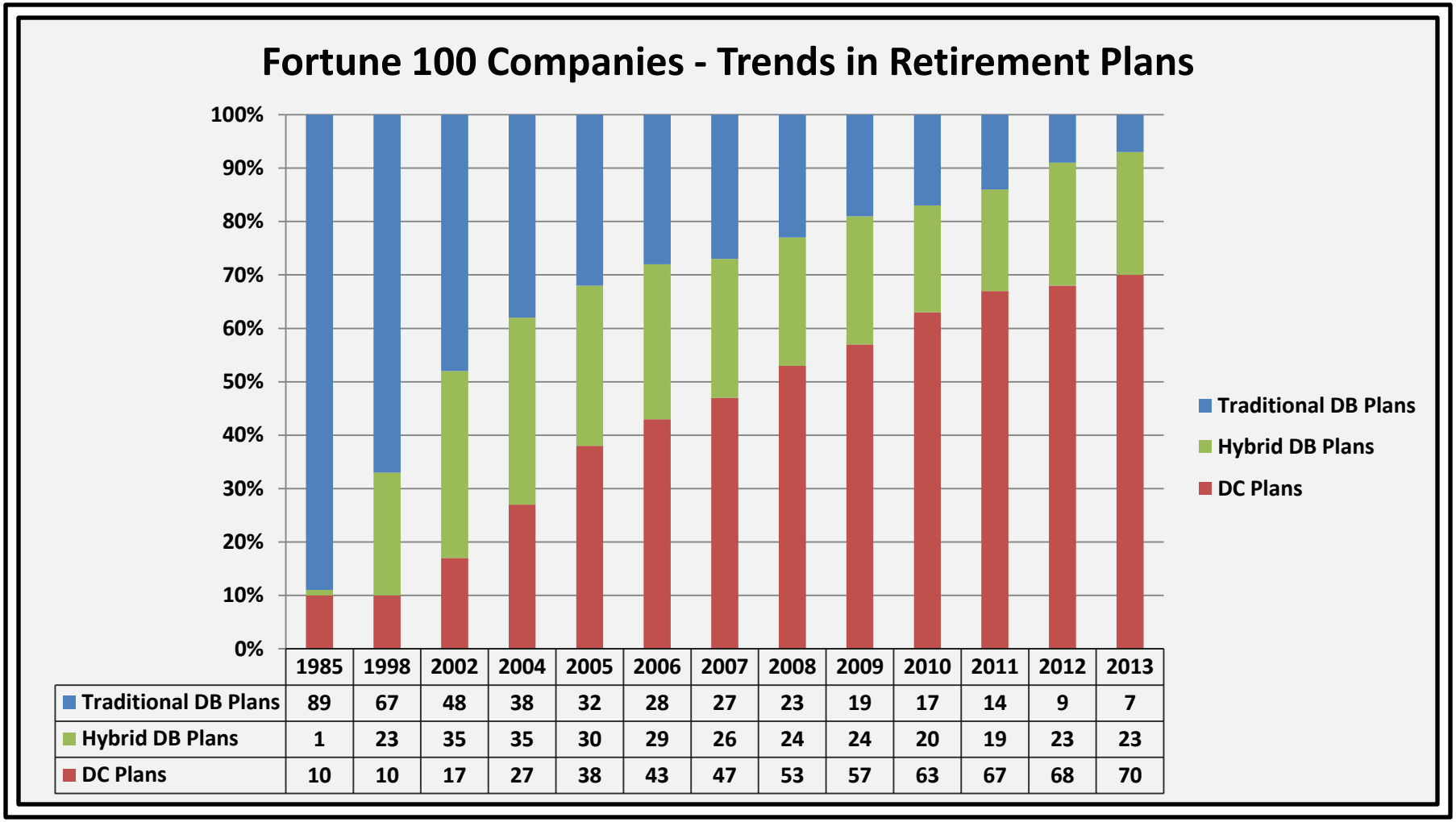
1) Poor Benchmarking

2) Poor Liability Management

3) Politics

Towers Watson Pension Survey
Average DC Employer Cost – 4.77% to 7.67%

http://www.towerswatson.com/assets/pdf/mailings/TW-21621_July-Insider.pdf



	1985	1998	2002	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Traditional DB Plans	89	67	48	38	32	28	27	23	19	17	14	9	7
Hybrid DB Plans	1	23	35	35	30	29	26	24	24	20	19	23	23
DC Plans	10	10	17	27	38	43	47	53	57	63	67	68	70

#2 Poor Liability Management

- **Few absolute metrics defining the affordability or reasonableness of pension costs given the "perpetual life of the government entity".**

- **The defined-benefit (DB) financial system for PSERS and SERS is predicated upon an annual investment return assumption of 7.5%.**

- **A 2011 Wilshire Associates study indicated none of the 126 state retirement systems (including PSERS and SERS) will be able to meet its actuarial assumed rates of return over the next 10 years. Likely return is estimated at 6.5%.**

- **A 2012 study by Welton Investment Corp yielded a composite forward expected annual return of 5.69% per annum for the next 7 to 10 years.**

- **A 2014 Independent Panel commissioned by the Society of Actuaries identified a long-term annual expected return of 6.4%.**

Recent National Headlines

- ***Experts tell CalSTRS earnings may fall short of 7.5% assumed rate***
  - **The CalSTRS board was told this month that financial experts are forecasting investment earnings of 7 percent a year or less during the next decade, below the 7.5 percent assumed by the pension fund.** ***Calpensions.com.*** **Posted Oct. 27, 2014**

- ***R.I. pension fund advisers suggest state consider further reduction of annual returns*** **– Providence Journal – September 12, 2013**
  - **The Cheiron (actuarial) team … says the board should "consider lowering" its assumed 7.5 percent rate of return because there is only a 40-percent chance the yields will be that good over a 20-year period.**

- **In his "You Only Dance Twice" outlook, Bill Gross said investors should lower expectations for stocks to 5% and 6% and for bonds, to 3% to 4%.**

- ***Rising U.S. Lifespans Spell Likely Pain for Pension Funds***
  Wall Street Journal - Oct 27, 2014
  - **Society of Actuaries Boosts U.S. Life Expectancies by About Two Years**

From the Credit Rating Agencies

July 16, 2013: Fitch cuts Pennsylvania credit rating, cites pensions

- "The funding levels of the Commonwealth's pension systems, which have been historically adequate, have materially weakened, with ***annual contribution levels remaining well below actuarially required levels***."

- Together, Pennsylvania's problems "***signal an inability or unwillingness on the part of political leaders to make difficult fiscal decisions,"***

Moody's (March 29, 2013) and Standard & Poor's (April 2, 2013) opinions expressed similar conclusions and outlooks.

#3 Politics

Pensions as political capital

- **Pension Fund Surplus =** Political Capital & Benefit Improvements for Participants and/or Retirees
- **Pension Fund Deficits =** Underfunding by Taxpayers
- **Maintaining or Improving Benefits = High** Political Rate of Return
- **Reforming and Properly Funding Plans = Low** Political Rate of Return

Politics and Defined Benefit Plans
A Toxic Combination

Politics means forces within the pension system responsible for the following actions, which can be carried out singly or in combination. The following can also be done repeatedly:

1) **The tendency to promise and perpetuate retirement benefits that are generally benchmarked only against other public-sector pension systems rather than their counterparts in the private-sector**

2) **The use of rosy economic assumptions to minimize current and future costs**

Politics and Defined Benefit Plans
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3) **Retroactively improving benefits or granting ad-hoc benefit improvements**

4) **The (re)deferral of liabilities to avoid either raising taxes or reducing budgets**

5) **The failure to make the Actuarially Recommended Contributions (ARC).**

6) **Postponing the attainment of a 100 percent funded ratio to a time well beyond the average remaining career duration of the current workforce**

True Pension Reform Must Satisfy Three Basic Principles – Using Realistic Funding Assumptions

1. Funding must be current.
   - Benefits should be funded as they are earned and "paid-up" in the aggregate at retirement. Achieving a 100% funded ratio.
   - PSERS average age is 44.5. Avg. retirement age 60.9

2. Costs must be predictable.

3. Costs must be affordable.
   - 4-7% of payroll (net of employee contributions)

Five Step Public Pension Reform Plan

1. **Establish a DC plan with an annual employer cost of 4% to 7% of pay. <u>No excluded groups</u> (Higher match for non-members of Social Security)**
   - Removes politics from pensions
   - No unfunded liabilities, portable benefits, individual accounts
   - Eliminates long-term taxpayer commitments
   - Total employee and employer contributions should target 12% to 15% of pay. Default investment option is "target (retirement) date" funds.

2. **Statewide prohibition of pension obligation bonds. This concept also precludes other borrowing strategies to finance benefit plans.**

3. **Adopt funding reforms <u>consistent with</u> Government Accounting Standards Board (GASB) Statements #67 & #68; 2014 Report on Public Pension Plan Funding and Moody's approach to valuing liabilities.**
   - Amortization periods for unfunded liabilities should be limited to no more than 20 years. Asset averaging should not exceed five years.
   - Actuarial assumptions should be at least 50% achievable

Five Step Public Pension Reform Plan

4. **Modifying unearned pension benefits** (as legally permitted)
   - This includes redefining early and normal retirement benefits and increasing member contributions,
   - Eliminating annual pension COLAs, Deferred Retirement Option Plans (DROPs)
   - Revising Other Post-employment Benefits (OPEB) (this includes retiree healthcare)

5. **Consider funding reforms only after prior steps are achieved**
   - Challenge is to do this without increasing taxes or through new borrowing

Omitting any steps ≠ comprehensive pension reform

Pseudo-Reforms – Avoid These Actions

Item	Why it is a problem
1) Using pension obligation bonds or other borrowing strategies to finance pension systems	Further leverages pension system and creates an incentive to improve benefits
2) Adopting early retirement incentive plans	Enhances already generous benefits; a false economy
3) "Fresh start" (reset) of any unfunded liability especially beyond the average remaining duration of the workers' career (usually 15 to 20 years). ➢ Other funding techniques that defer costs, including assigning these costs to new employees	A political dodge that burdens future generations.
4) A new and reduced DB plan and/or an optional DC plan	Neither will escape the politics of public pensions
5) A "hybrid" DB plan: a cash balance DB or a reduced set of DB and DC plans	Same politics and funding issues associated with all defined benefit plans

Correcting Common PA Pension Half- Truths

#	Half-Truth	Important Fact
1	Transition costs (TC) in closing a DB plan should preclude consideration of a DC plan.	TC are significantly overstated and should not preclude closing a DB plan. Consider private sector experience
2	Michigan and Alaska experienced a significant increase in the unfunded liability (UL) after closing their DB plans	Increases in the UL were related to underfunding and poor investment returns.
3	DB plans are 48% cheaper than DC plans to provide equivalent benefits.	Based upon very debatable assumptions. Conflates group pooling with individual accounts.
4	Act 120 (2010) just needs time to work	The 2010 projected expected savings <u>will not materialize</u> due to lowered asset return assumptions & reduced number of active participants.

Correcting Common PA Pension Half- Truths

#	Half-Truth	Important Fact
5	The unfunded liability reflects the deficit assuming everyone retired today	Generally, this deficit is the value, in today's dollars, assuming members retire on their expected dates.
6	The DB annual normal cost (NC) is the true measure of long-term pension costs. The NC can be readily compared to the annual DC employer match.	If true, then why do we have any unfunded liabilities? NC is simply an estimated deposit based upon the actuarial assumptions and other variables. It does not reflect any unplanned events including underfunding.
7	New entrants are required to sustain a DC pension plan.	Such claims are not associated with properly funded pension plans.
8	The PSERS & SERS uncollared contribution rates represent the appropriate pension funding standards.	Need to adopt pension funding reforms including shortening amortization funding periods.