The Universal Retirement Equation

\[ C + I = B + E \]

Contributions plus Investment Earnings equals

Benefits plus Expenses
A Brief History of Public Pension Funding

• Public pensions were exempted from ERISA, which established corporate pension funding requirements beginning in the 70s

• In the absence of a single, one-size-fits-all requirement, the public pension community struggled to identify a common funding standard

• GASB statements 25 (for pensions) and 27 (for employers), prescribed the Annual Required Contribution (ARC), which became the de facto public pension funding standard

• Statements 25 and 27 took effect beginning in FY 96 and FY 97, respectively

• Compliance with 25 and 27 was not perfect, but the new standards improved funding levels for many plans

• “The Miracle of Public Pension Funding”
Uneven experience: Distribution of changes in percentage funding level, FY 01 to FY 13

Median = -25.3%
Factors affecting a pension plan’s funding condition

- Contribution adequacy
- Actuarial assumptions vs. experience
- Actuarial methods
- Legal rulings
Distribution of change in percentage funding level and ARC experience, FY 01 to FY 13
Spotlight on
The Annual Required Contribution Experience of State Retirement Plans, FY 01 to FY 13

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Executive Summary
After its creation in the 1990s, the annual required contribution (ARC) quickly became recognized as the unofficial measuring stick of the effort states and local governments are making to fund their pension plans. A government that has paid the ARC in full has made an appropriate funding to the pension trust to cover the benefits accrued that year and to pay down a portion of any liabilities that were not pre-funded in previous years. Assuming projections of actuarial experience hold true, an allocation short of the full ARC means the unfunded liability will grow and require greater contributions in future years.

This study evaluates the ARC that was received by 112 state public pension plans, including the District of Columbia, from fiscal years 2001 to 2013. This study finds that although variation exists in ARC effort among states and pension plan sponsors, i.e., cities, school districts, etc., most governments made good faith efforts to fund their pension plans, and only a few severely neglected their pension funding responsibilities. This ARC experience unfolded during a tumultuous period, as capital markets declined sharply in 2000-02 and again in 2008-09, and states and local governments twice experienced economic recessions. Combined with other factors, the market declines caused required pension contributions to rise significantly, while the economic recessions challenged the ability of states and local governments to respond.

States and their political subdivisions establish and maintain funding policies in the form of statutes, ordinances, board rules, and case law that prescribe how public pension benefits will be funded. While federal regulations governing private sector pension plans often are cited as onerous and creating volatility and uncertainty, funding policies for public plans typically are designed to establish contributions that will remain approximately level as a percent of payroll over time. This objective is intended to promote intergenerational cost equity and budget predictability.

Although many factors play a role in determining how a pension plan is financed, this study finds that plans with strong required contribution governance arrangements generally have received a significantly higher portion of their ARC during this study’s measurement period. Some states, however, have consistently received a high portion of their ARC even without a statutory requirement to do so. Conversely, some of the plans that have received a small portion of their ARC, have statutory requirements but failed to receive their ARC. Nevertheless, even in the periods of recession during this study, most state and local governments increased pension contributions and continued to provide pension benefits for former, current and future employees.

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The ARC Experience of Statewide Retirement Plans: Key Findings

- Policies (statutes, constitutional provisions, retirement board requirements) that require payment of the ARC generally produced better pension funding outcomes than policies that do not.
- Some plan sponsors consistently paid their ARC without a requirement to do so.
- Some states that have statutory requirements still failed to fund their pension plans.
- Policy constraints that limit payment of the actuarially determined contribution were more likely to negatively affect the ability of employers to fund the pension plan.
Change in ARC, ARC received, and combined shortfall, FY 01 to FY 13

Source: NASRA, AARP
Distribution of weighted average ARC received, FY 01 to FY 13, by state

Source: NASRA, AARP
Weighted ARC Received Based on Contribution Policy, FY 01 to FY 13

- Explicit or Implicit ARC Requirement: 98%
- Fixed Rate Contribution Policy: 79%
- Other: 68%

Source: NASRA, AARP
Median and weighted average ARC received, FY 01 to FY 13

Source: NASRA, AARP
Employer (taxpayer) spending on public pensions, 1984 to 2013

Source: NASRA, AARP
New Jersey TRS and PERS* ARC Experience

NASRA: The Annual Required Contribution Experience of Statewide Retirement Plans, FY 01 to FY 13

*State share
New Jersey’s Contribution Controversy

• A 2011 political agreement called for state contributions to increase steadily over seven years until reaching the actuarially-determined amount
• In 2014, Governor Christie announced that the state could not afford to make its contributions pursuant to this agreement
• Employee groups filed suit
• A 2015 state supreme court ruling found in favor of the governor, saying a) the agreement to fund the pensions is not an enforceable contract; and b) the matter was one for the executive and legislative branches to work out, not the judiciary
• “Responsibility for the budget process remains squarely with the Legislature and Executive ... This is not an occasion for the Judiciary to act on the other branches’ behalf.”
ARC Experience: CalPERS vs. CalSTRS

CalPERS

CalSTRS
Restoring CalSTRS’ Funding Position

• 2014 legislation established a new funding requirement for CalSTRS that will increase required contributions from teachers, the state, and especially school districts.

• Under the new requirements, CalSTRS is on a path to sustainability rather than insolvency

• Employee rate 8.0% to 10.25%
• State rate: 3.041% to 6.328%
• School districts: 8.25% to 19.1%

• Rates paid by employees hired since 2013 differ slightly
New GASB Pension Standards

- Statement 67 affects pension plan reporting and takes effect in FY 2014
- Statement 68 affects employer reporting that sponsor pension plans and takes effect in FY 2015
- Statement 67 eliminates the ARC and shifts the focus from the plan’s funding position to its accounting position
- Statement 68 requires employers to place their proportionate share of the pension liability on their basic financial statements
- New standards are accounting-focused and do not prescribe how to calculate a required contribution, i.e., an ARC
- Both statements require reporting of Actuarially Determined or Contractually Required (i.e. statutory) Contributions, except for Statement 67 for agent plans
Arizona Pension Funding Policy

Arizona State Constitution Article XXIX: “public retirement systems shall be funded with contributions and investment earnings using actuarial methods and assumptions that are consistent with generally accepted actuarial standards.”

AZ Revised Statutes 38-737: "The total employer contributions shall be equal to the employer normal cost plus the amount required to amortize the past service funding requirement over a rolling thirty-year period."
Washington State Pension Funding Policy

Wash. Rev. Code § 41.45.060

“The [pension funding] council may adopt annual rate changes for any plan for any rate-setting period. The contribution rates adopted by the council shall be subject to revision by the legislature.”
NASRA encourages all state and local retirement systems to adopt a clear funding policy that specifies:

- Funding goals
- Target funding levels
- Commitment to meet actuarially determined contributions, and
- Strategies to maintain predictable and level costs that are aligned with affordable and sustainable plan designs that provide secure lifetime retirement income.

RESOLUTION 2011-01 - FUNDING DISCIPLINE IN PUBLIC EMPLOYEE RETIREMENT SYSTEMS

WHEREAS:
- Public employee retirement plans are designed to meet human resources objectives of recruitment and retention of their sponsoring governmental entity, as well as the public policy goal of providing state and local government employees with balanced, appropriately funded and secure income in retirement, usually through a plan that provides for systematic distribution of benefits over their post-employment lifetime; and
- State and local government retirement system assets are held in trust and dedicated to the payment of future retirement income disbursements; and
- It is a fundamental objective of public employee retirement systems to establish and receive contributions which will remain approximately level as a percent of payroll over time to ensure affordability and sustainability of benefits, intergenerational cost equity and consistent budgetary operations; and
- Predictability and stability of required costs are the foundation of public sector budgeting and enable policymakers and ultimately taxpayers to assess the underlying true cost of any long-term public program, and the maximization of elements that would cause wide swings in required pension costs would be unnecessarily financially disruptive, confusing and counterproductive, and
- Disciplined funding of public employee retirement systems is critical to minimize costs, maximize investment returns, and ensure the long-term viability of the trust; and
- Established funding policies can benefit retirement plans, participants, employers, and other stakeholders by clearly defining target funding goals, policies to stabilize contributions over time and a commitment to sound financing; and
- Benefit adjustments should be made only in conjunction with an analysis of employer and employee needs and a savings plan to finance the cost of adjustments in accordance with the funding policy;

NOW, THEREFORE, BE IT RESOLVED that the National Association of State Retirement Administrators:
- Supports disciplined funding of established benefits and efforts to ensure the financial integrity of public and private retirement systems, and encourages all state and local retirement systems to adopt a clear funding policy that specifies funding goals, target funding levels, commitment to meet actuarially determined contributions, and strategies to maintain predictable and level costs that are aligned with affordable and sustainable plan designs that provide secure lifetime retirement income.

Amended Resolution 1996-02
Amended Resolution 2005-03
Adopted on August 10, 2011
Pay at least the Actuarially Determined Contribution

Use the entry age method (now required for GASB compliance)

15 to 20 year amortization period

Asset smoothing of no more than five years
Pension funding policies should be based on the following policy objectives:

1. An actuarially determined contribution.
2. Build funding discipline into the policy to ensure that promised benefits can be paid.
3. Maintain intergenerational equity so that the cost of employee benefits is paid by the generation of taxpayers who receives services.
4. Make employer costs a consistent percentage of payroll.
5. Require clear reporting to show how and when pension plans will be fully funded.
Final Thoughts

State and plan-specific funding policies have an effect on the level of contributions public pension plans receive.

A broad consensus exists on components of a sound funding policy:

- Pay the Actuarially Determined Contribution
- Use a valuation method that produces level cost as a percentage of payroll
- Smooth asset gains and losses over a period of five years or less

“Negative amortization” can be misleading and is not, per se, a problem or an indication of actuarial malfeasance, but should be clearly disclosed.

State policy should focus on broad, high-level objectives; plan policy should be more detailed, specifying funding method, objectives and funding targets.

Avoid a federal or one-size-fits-all solution.

Evidence suggests that many states, cities, and policymakers have developed an increased appreciation for the importance of properly funding pensions.