# Public Pension Funding Issues: Myths and Realities

The Voice for Public Pensions

Institute on Public Pension Solutions

Everyone deserves a great pension plan

**Keith Brainard**
Research Director
National Association of State Retirement Administrators
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# Public pension plan myths

1. Unfunded liabilities are unsustainably high
2. Public pension liabilities should be discounted using a risk-free rate
3. Taxpayers cannot afford it
4. Defined benefit plans should be closed and switched to defined contribution plans
5. Pension plans are seeking a federal bailout

# Unfunded liabilities are unsustainably high

In fact:

- Unfunded pension liabilities vary widely among states, cities, and plans
- Unfunded liabilities for the vast majority of states, cities and plans are manageable
- The largest unfunded liabilities are attributable primarily to employers' failure to pay actuarially determined contributions

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# Unfundeded liabilities are unsustainably high (cont.)

- Pension plan obligations are paid over many years, which provides time to generate contributions, investment returns, and to alter benefits and financing arrangements
- As a percentage of all state and local government revenues projected over the next 30 years, required pension costs are only a small portion

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# Pension liabilities should be discounted using a risk-free rate

- Using a risk-free rate to discount liabilities is based on an economic theory
- Using a risk-free rate implies that public pension fund returns are or should be linked to bond markets
- Current risk-free rates are around 2.35 percent
- Public pension fund assets are invested in diversified portfolios that can be expected to generate long-term investment returns of 3 to 5 percent above the rate of inflation

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# Pension liabilities should be discounted using a risk-free rate (cont.)

- Discounting public pension liabilities at a risk-free rate would cause unfunded liabilities to skyrocket and would lead to misunderstanding and misuse of the calculated numbers
- Using a risk-free rate to discount liabilities falsely implies that public pension liabilities are for sale

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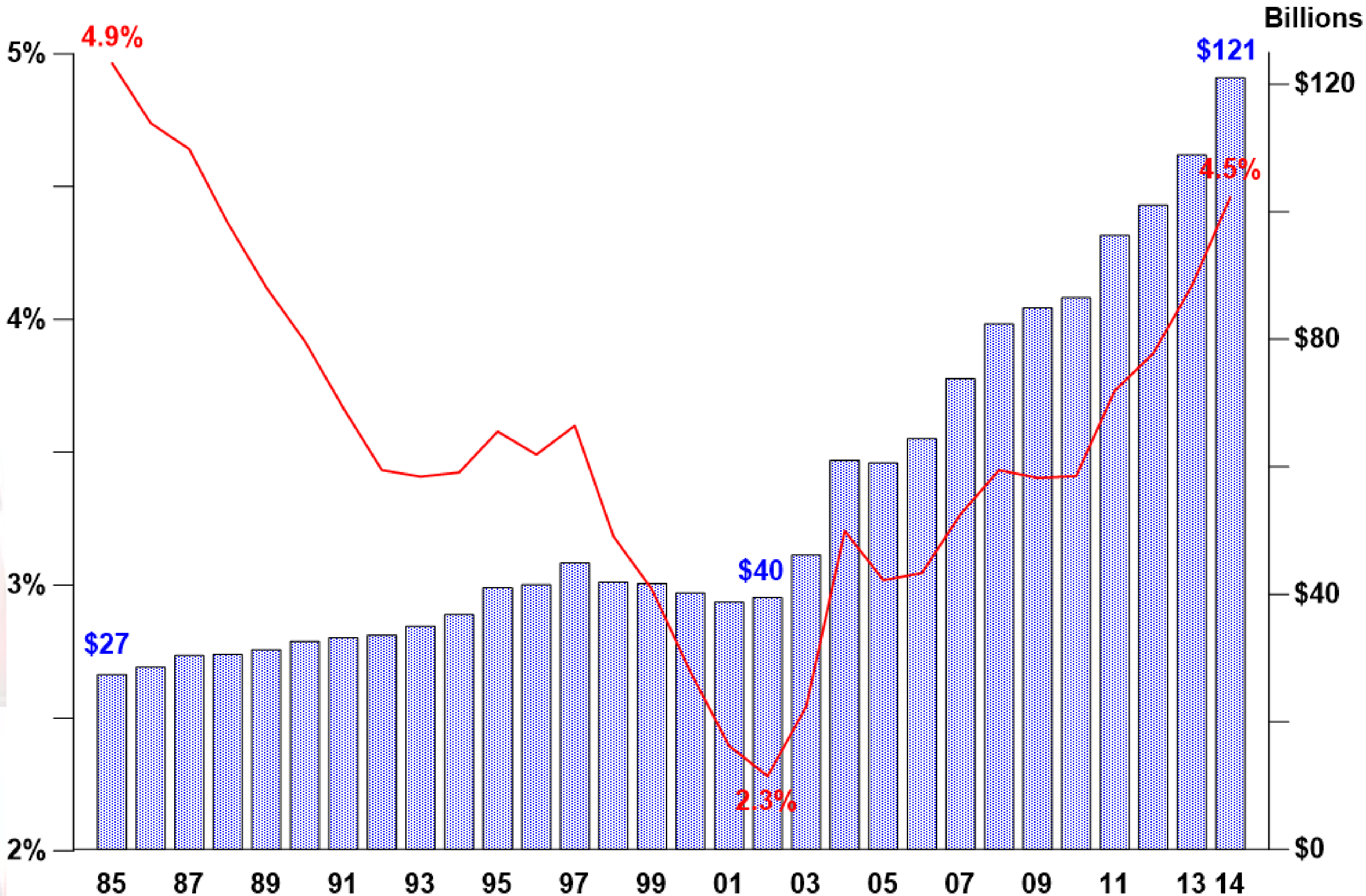
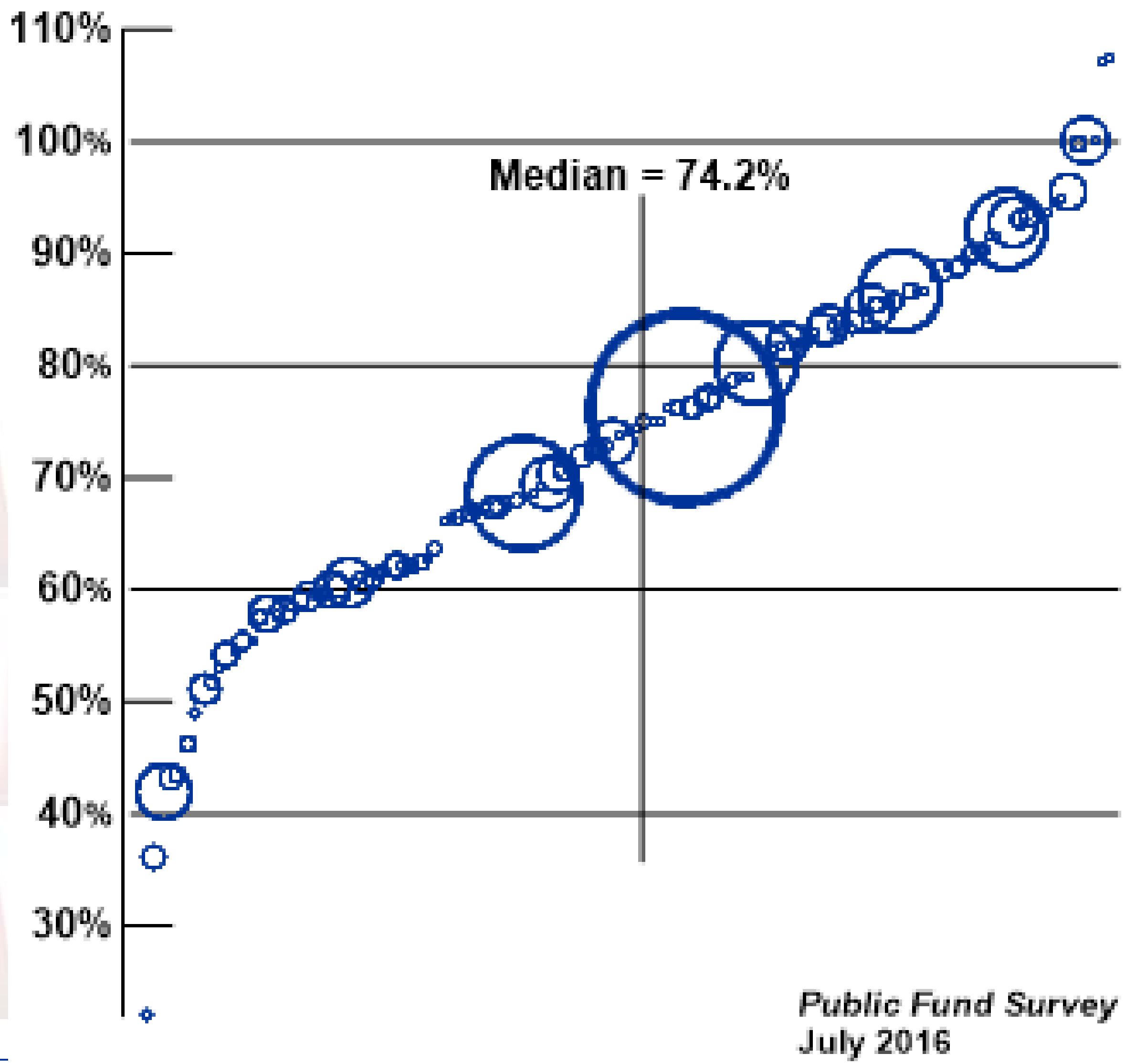
# Taxpayers cannot afford it

- Spending on pensions accounts for approximately four percent of all state and local government spending, excluding spending from federal funds
- Required spending levels need to be higher for some plans and are sufficient for others
- Many studies have documented the positive economic effects of pension plans
- Pension plans help prevent participants from becoming reliant on public assistance, which is much more expensive than a pension plan

# Employer (taxpayer) spending on public pensions, 1985 to 2014



# Latest Public Pension Funding Levels




*Size of bubbles is roughly proportionate to size of plan liabilities*

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# Defined benefit plans should be closed and switched to defined contribution plans

- Closing a defined benefit plan does not reduce costs and usually will increase costs, at least in the near-term
- Public pension obligations are promises that must be fulfilled
- Defined contribution plans are poor vehicles for delivering an assured source of retirement income
- The appropriate response to a public pension funding problem is to properly fund the plan, make needed adjustments, or both

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# Public pension plans are seeking a federal bailout

- No public pension plan has requested a federal bailout

- The public pension community and its sponsoring states and local governments expect and intend to resolve their funding challenges themselves

# Key Takeaways

- Generalizations about the public pension community are usually wrong
- Every public pension plan is unique
- Understanding the condition of the public pension community requires understanding individual systems, plan designs and funding situations, and fund investment strategies and outcomes

# NCPERS Public Pension Funding Forum

## New Haven, Connecticut

# *Public Pension Funding Issues: Myths and Realities*

Leigh Snell, Director of Federal Relations
National Council on Teacher Retirement
August 22, 2016

# The "Good Old Days"

- 1996: 415(m) excess benefit arrangements; 457 plan assets put in trust.
- 1997: Section 415(n) purchase of permissive service credits enhanced; permanent moratorium on nondiscrimination testing.
- 2001: use of 403(b), 457 plan assets to buy service credits through direct trustee-to-trustee exchanges; catch-up contributions to 403(b) plans.
- Regulatory issues: 2007 Normal Retirement Age regs; 2008 IRS public pension roundtable, survey.
- GASB PV on pension accounting, financial reporting
- SEC focus on corporate governance.

# That was Then -- This is Now!

- MVL and the discount rate controversy explodes!
- GASB Statements 67, 68; Moody's restatement of liabilities; bond lawyers (NABL) disclosures.
- SEC: Pay-to-Play; New Enforcement Unit on Public
- Pensions; NJ, IL, KS settlements.
- National Commission on Fiscal Responsibility and Reform ("Deficit Commission") proposes mandatory Social Security as a means of reforming State and local pension systems to make them "more sustainable" and to avoid the need for a Federal bailout of public plans.
- PEPTA (2010); Hatch SAFE Annuities bill.
- Arnold Foundation founded; partners with Pew in 2012.

# A Persistent Drumbeat!

- Public Plans are going broke!  Unfunded liabilities are $3, $4 trillion – maybe as high as $15 TRILLION!
- Public Plans are bankrupting cites and states!  San Bernardino and Stockton, CA!  Central Falls, RI! Detroit!! Puerto Rico!!!
- Public Plans are taking too many investment risks! “Rosy” investment return assumptions lead to Hedge funds! Alternative investments! Private equity!
- Public Plans are unfair to young teachers; lack portability!
- Unfunded Public Pension “legacy” costs are denying schools needed monies for expansion, modernization!

# Who?

- Ancient History: Grover Norquist
- Conservatives/anti-union; anti big government
- Big business – US Chamber of Commerce; Business Roundtable
- Politics: American Legislative Exchange Council (ALEC)
- Big money: Koch brothers; Laura and John Arnold

# Why?

- Stop “corporate governance” interference
- Take power away from unions; “downsize” government
- Justify corporate America’s abandonment of DB pensions
- Divert attention from national retirement crisis
- “The only people making money off of DB plans are the participants”

## What?

- Public Employee Pension Transparency Act (PEPTA)
- Secure Annuities for Employee (SAFE) Retirement Act

# Public Employee Pension Transparency Act PEPTA

- HR 4822 (Nunes)
- Sponsors of state, local plans to report funding info annually to Treasury using market value of liabilities (MVL), no asset smoothing; Treasury could impose new, yet to be defined "comparability" standards.
- "Voluntary," but failure to report would lose sponsor the Federal tax-exempt treatment of muni bonds.
- Prohibits Federal bail-out of public pension debt.
- Only 8 cosponsors

# Congressional Hearings in 2011

- 2/9/2011 – “State and Municipal Debt: The Coming Crisis?”
- 2/14/2011 – “The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter”
- 3/15/2011 – “State and Municipal Debt: The Coming Crisis? Part II”
- 4/14/2011 - "State and Municipal Debt: Tough Choices Ahead”
- 5/5/2011 – “Transparency and Funding of State and Local Pension Plans”

# PEPTA Talking Points

*PEPTA creates worrisome precedent regarding Federal regulation of state, local governments and taxation of their bonds.*

- Mandates costly, complex layer of Federal reporting on top of existing state and local accounting and reporting.
- Gives Federal regulators sweeping powers to impose duplicative requirements on State, local governments.
- Jeopardizes state and local financing of infrastructure and other critical needs by stripping tax exempt status of bonds if new regs are not met to the regulators' satisfaction.
- Creates confusion as to which entities are required to report what information to the Federal government and imposes catastrophic fiscal penalties for simple, unintended errors.
- Threatens far-reaching, unintended consequences for the municipal bond market and the economy as a whole.

# PEPTA Talking Points

*PEPTA falsely depicts the true condition of state and local governments and their retirement systems.*

- Requires State, local governments to report as though they are invested only in U.S. Treasuries, not the diversified portfolios actually in use, creating a false picture of the true condition of public pensions and misleading taxpayers, alarming retirees, frightening investors and confusing policymakers.
- Creates false impression that one state's pension system can be directly compared with that of another state by ignoring important differences in the sovereign entities and political subdivisions that sponsor these programs, as well as the unique demographic make-up, cost-of-living, inflation factors, mortality rates, and fiscal condition of each.

# PEPTA Talking Points

*PEPTA does NOT lower taxpayer costs.*

- The Federal government does not guarantee state and local government employees' pensions, and no public pension plan is asking for Federal financial assistance.
- At a time when both Congress and the Administration want to remove regulatory barriers, this bill would impose complicated, costly Federal mandates.

*PEPTA does NOT increase transparency.*

- Public pensions are currently required to report all of their financial data in Comprehensive Annual Financial Reports (CAFR), which are audited, publicly available and can be easily accessed by anyone, and contain considerable information about liabilities, asset values, assumptions, rates of return, and annual required contributions.

# PEPTA Talking Points

*PEPTA does NOT improve public pension accountability.*

- Public plans are already required to adhere to strict accounting standards set by GASB, which regularly reviews the reporting requirements of states and localities, and in the last few years considered the alternative valuation of liabilities proposed by PEPTA, and decided against it.
- In the last several years, an unprecedented number of States have made changes to their pension benefits, contribution requirements, or both – all done without the need for Federal intervention.
- One-size-fits-all Federal mandates do not allow States and localities to adopt tailored solutions to meet their unique long-term needs. PEPTA sets a dangerous precedent with regard to Federal taxation of State and local government bonds and simply makes poor public policy.

# PEPTA: *Something New!*

The Actuarial Standards Board (ASB), based on the report of its Pension Task Force, has directed the ASB's Pension Committee to draft proposed changes to the pension actuarial standards of practice (ASOPs) to include a requirement that a market-based alternative liability measurement be calculated and disclosed for all valuations of pension plans for funding purposes.

This "solvency value" should represent an estimate of "the cost, as of the valuation date, to defease all liabilities accrued under the plan in the marketplace, based upon the presumption that capacity is available." An acceptable proxy for this would be to calculate the present value of future benefits accrued to date using the unit credit method and U.S. Treasury rates.

# The Secure Annuities for Employee (SAFE) Retirement Act

- New DB pension plan called an "Annuity Accumulation Retirement Plan," introduced by Senator Orrin Hatch (R-UT), Senate Finance Committee Chairman, in 113th Congress.
- Permissive: State and local governments could purchase fixed annuity contracts from insurance companies for each employee every year during their working career. Life insurance industry would pay the pensions and bear all the investment risk.
- Hatch claims the bill would eliminate pension plan underfunding prospectively, while delivering lifetime retirement income to employees.

# Problems with Hatch Annuity Bill

- Existing DB plans would remain as closed plans, so costs would increase; doesn't address existing UAAL.
- Unsure level of income replacement; research suggests that it is is significantly lower than current DB systems for the same cost.
- No requirement that once begun, annual purchase of annuities must continue or be consistent; employees will have no way to plan for retirement.
- State insurance guarantees vary widely; are NOT pre-funded.
- Practical concerns of elderly potentially keeping up with dozens of individual annuity checks each month.
- No survivor and disability benefits.
- Once one state decides to try it, others are likely to follow.
- NIRS: for same level of benefits funded with annuity purchases over a working career, "the cost can be anywhere from 57% to over 175% more than that of the DB pension plan."

# Hatch Annuity Bill: *Something New!*

- RFP "not less frequently than every 5 years," instead of mandating an annual process;
- No longer a limit on largest allocation to any one annuity provider (was 75 percent);
- Authority to use a group annuity contract, and not just individual annuity contracts;
- Removal of language that would require each employee's entire interest under an annuity contract to be fully guaranteed by a State guaranty association;
- Change in the permissible annuity start date from no earlier than age 57 to 50 for public safety, 67 to 62 for others; and
- "Employer option" to provide "alternative benefit forms," including joint and survivor annuity and up to 3% COLA adjustment.

# Closing Thoughts

- Despite the fact that the 2008-09 market decline reduced public pension asset values by 25 percent, they were once again above their 2007 peak by 2013, AND this was accomplished at the same time that public plans distributed more than $1 trillion in benefits to more than eight million retirees and their survivors, and required, on a nationwide basis, only about 4 percent of all state and local direct general spending in order to do so.
- Really big numbers are only meant to scare people. For example, in 2014, Pew reported that state pensions had incurred unfunded liabilities of about $1 trillion. But looked at another way, this shortfall was equal to approximately 0.2 percent of projected GDP over the next thirty years, the period over which the shortfall would have to be filled; alternatively, it was equal to about 2.0 percent of projected state and local tax revenues over this same period.

# One last thing….

How about a different approach to the way in which we discuss our unfunded liabilities.

- We only have them because pensions are pre-funded. Think about it!

- What about our $3 trillion in <u>funded</u> liabilities? Why don't we talk more about that number, and what it means to our economy?