Defined Benefit Pension Policy and Efficiencies

Houston Long Range Financial Management Task Force

Monday, December 5, 2011

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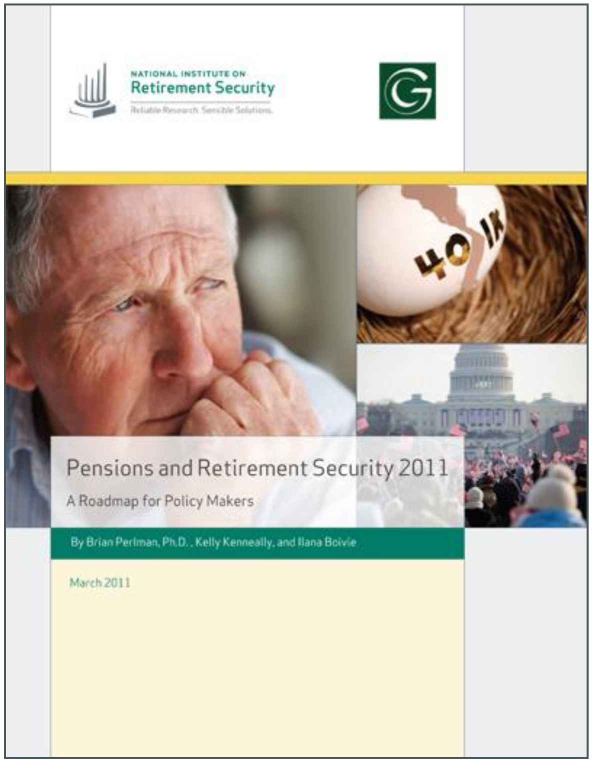
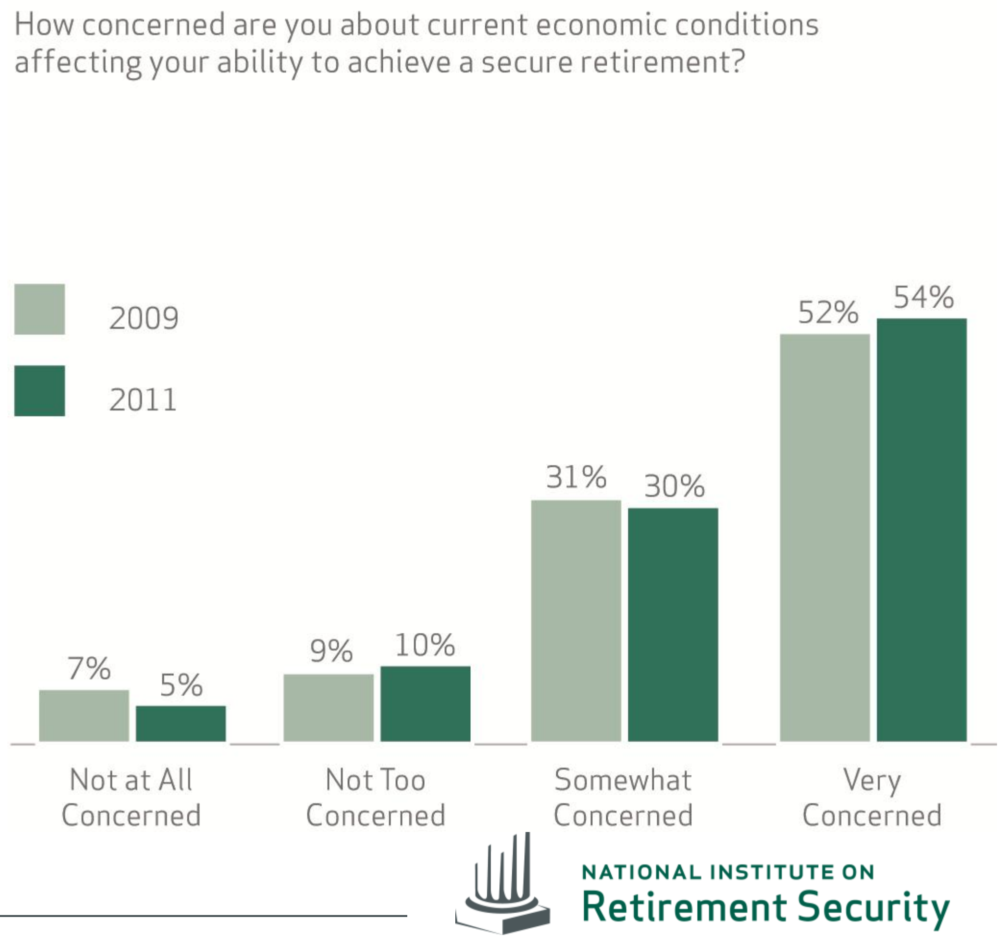
Pensions and Retirement Security, 2012 Public Opinion Research



- Americans highly anxious about retirement.
- Americans have low retirement expectations.
- U.S. retirement system stressed, needs reform.
- Pensions relieve anxiety, are reliable.

American Retirement Panic Attack

84% of Americans concerned about ability to achieve a secure retirement.



Source: National Institute on Retirement Security, *Pension and Retirement Security 2011, A Roadmap for Policymakers*

Adjusting Retirement Expectations

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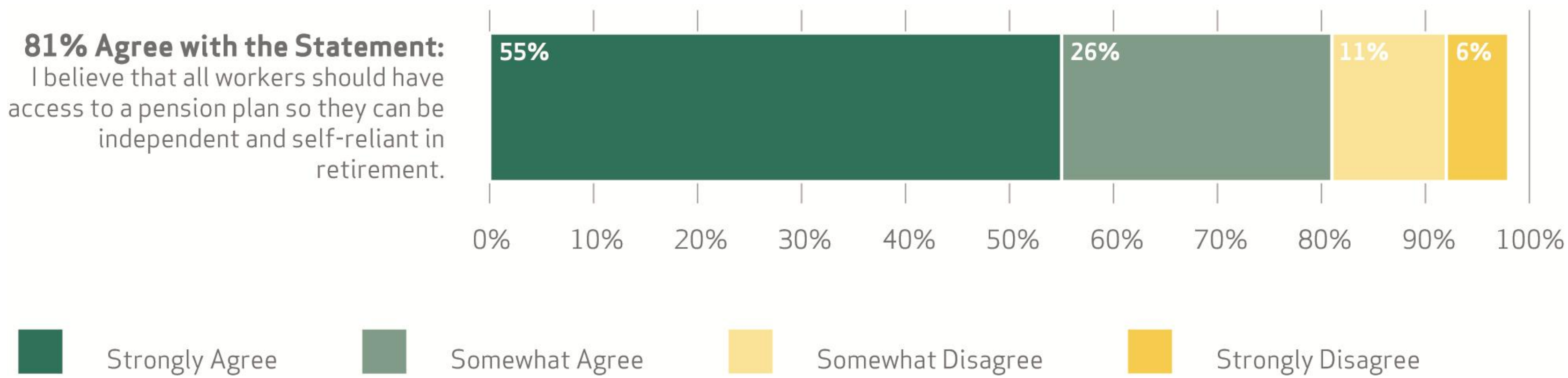
Private Sector Wants Pensions

81% of Americans Say They Need Pensions For Independence, Self-Reliance



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Source: Pensions and Retirement Security 2011: A Roadmap for Policy Makers, NIRS

Important to Keep Focus on Retirement Policy

- Retirement security benefits everyone
- An employer-sponsored retirement benefit can serve as a workforce management tool and old-age poverty insurance
- As a stable employer, government is well-suited to sponsor pensions.
- Core elements of pension promote retirement security:
  - Mandatory participation
  - Employee-employer cost-sharing
  - Pooled assets invested by professionals
  - Benefit adequacy
  - Lifetime benefits

Source: NASRA, *The State Landscape on Pensions*, 2011

Public Pension Stakeholders

The purpose of providing a retirement plan is to achieve key stakeholder objectives. Who are the stakeholders in public pension plan?

- **Employers,** who seek to attract and retain qualified workers needed to perform essential public services and have orderly workforce turnover
- **Taxpayers,** who seek the provision of public services at a cost that is fair and reasonably stable and predictable (also seek to minimize dependence on public assistance)
- **Employees,** who seek compensation that is competitive and a retirement benefit that promoted retirement security

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Source: NASRA, *The State Landscape on Pensions*, 2011

Distinguishing Features of the Public Sector Workforce

- More public employees work in professions that involve physical risk: law enforcement, firefighting, corrections, hazardous materials
- Many public sector positions are career-oriented, such as education, finance, and public safety
- A public employee is almost twice as likely to have a college degree than a private sector worker
- Public sector worker median tenure is 7.0 years, compared to 3.5 for the private sector

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Source: NASRA, *The State Landscape on Pensions*, 2011

Heartland Institute: Pensions Make Sense for Public Sector

"State and local governments also have a strong comparative advantage relative to private industry in offering pension benefits."

Since many of the most common government jobs – firefighter, police officer, corrections officer, regulatory overseer - have no direct private sector analog. The lifetime-with-one employer career path scorned by many in the private sector makes a lot of sense for government employees."

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Source: Eli Lehrer, Heartland Institute, *Weekly Standard*, March 28, 2911

Distinguishing Elements of Public Pension Plans

- Mandatory participation
- Employee-employer cost sharing
- Assets that are pooled and professionally invested
- An adequate benefit that can not be outlived

These features promote retirement income security.

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Source: NASRA, *The State Landscape on Pensions*, 2011

Investment Earnings Do Much of the Work Over Time

- Pension fund receipts over the past 15 years have been composed of:

- Employers (taxpayers) contribute 21 cents on the dollar of total pension receipts.

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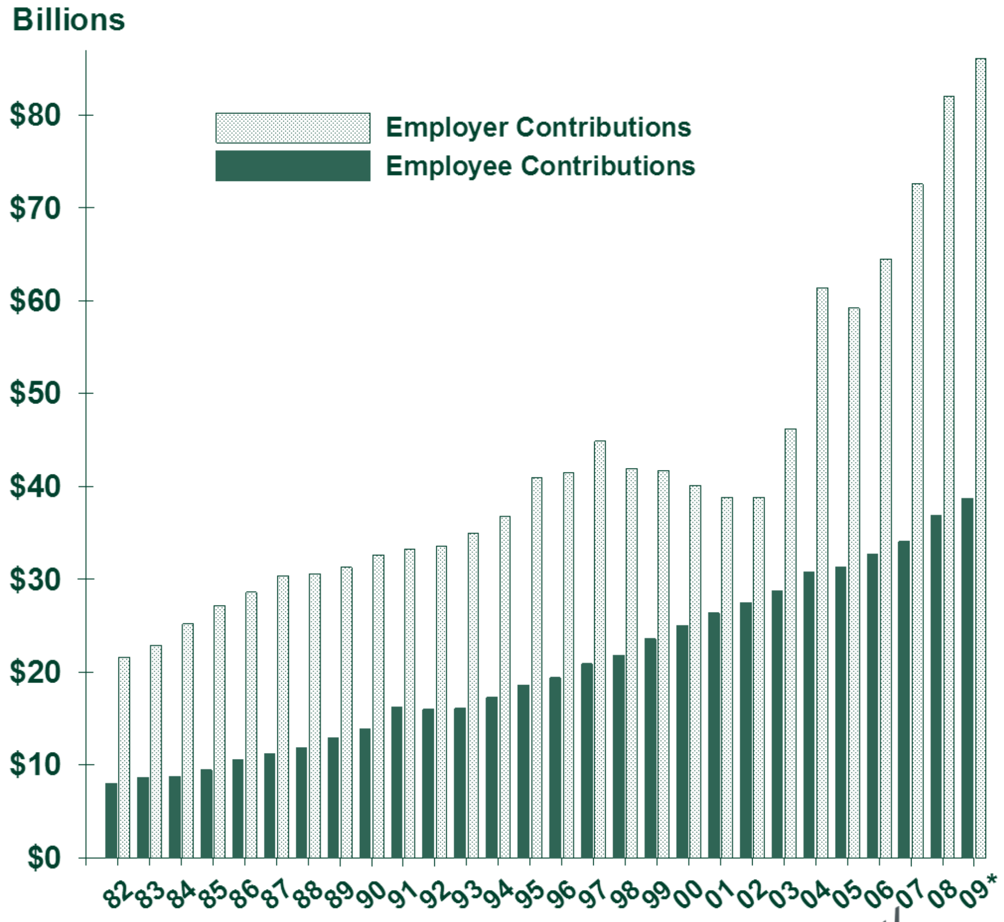
Source: U.S. Census Bureau, *State and Local Government-Employee Retirement Systems,* 2010

Public Pensions Typically Are Shared Funding Responsibility

Employee and Employer Pension Contributions, 1982 to 2009



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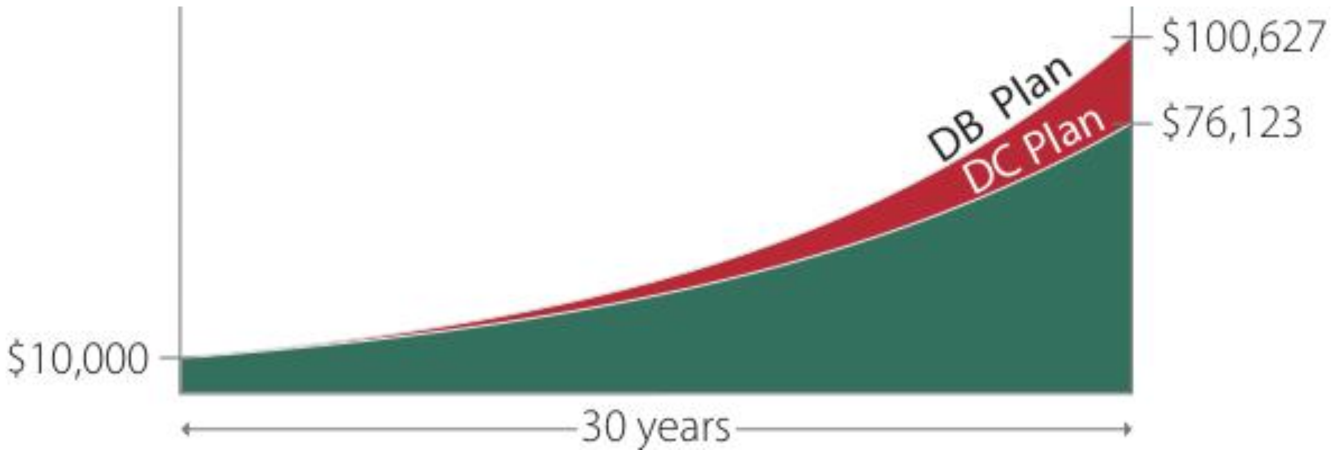
Source: U.S. Census Bureau

Professional Investment Managers Achieve Higher Returns

- Pensions achieve better investment returns than 401(k) type plans.
- These additional returns really add up over time.

How $10,000 Invested Grows over 30 Years



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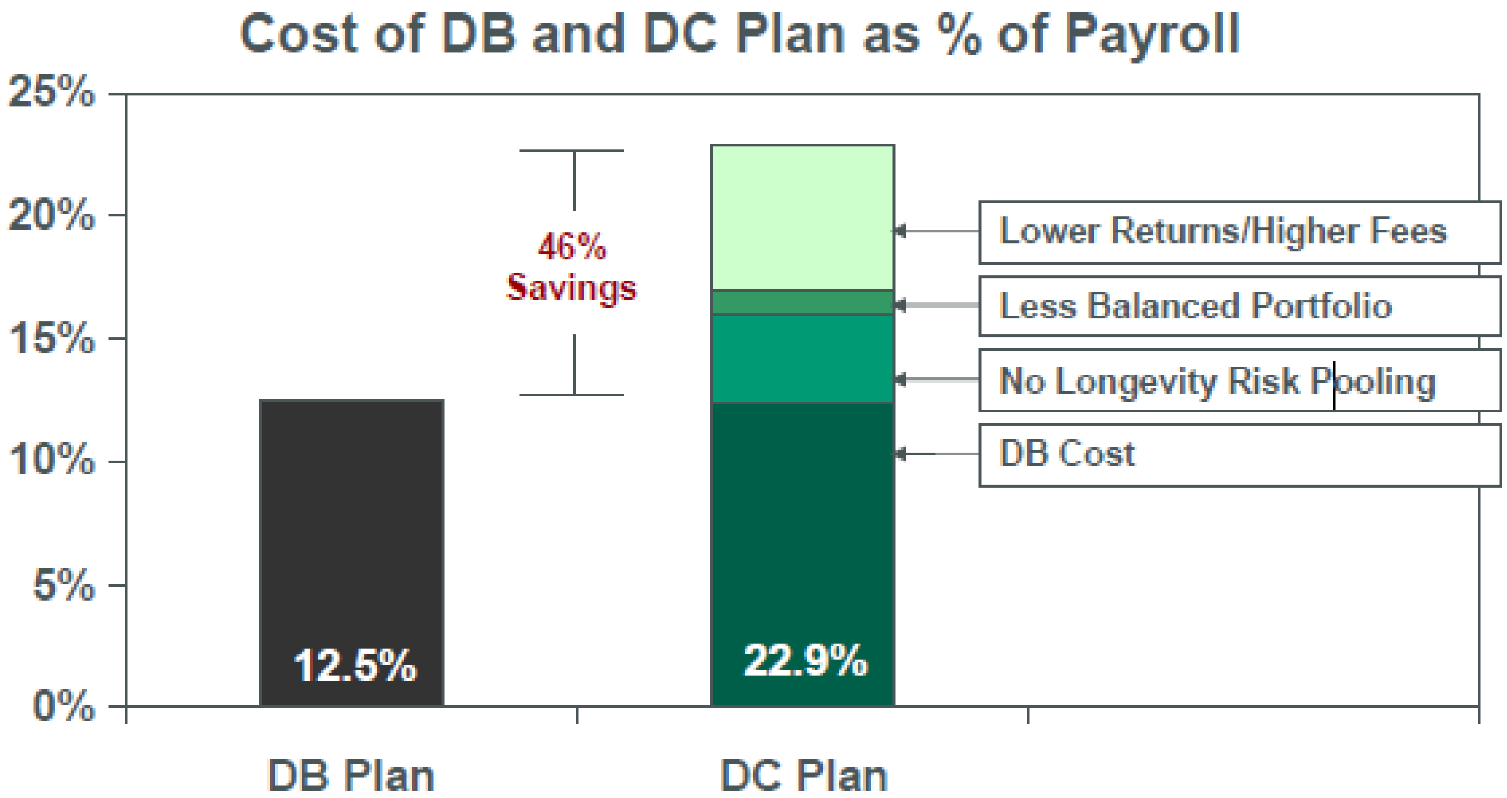
Source: A Better Bang for the Buck, NIRS, 2008

DB Plan Can Deliver Same Benefit at About Half the Cost of DC Plans



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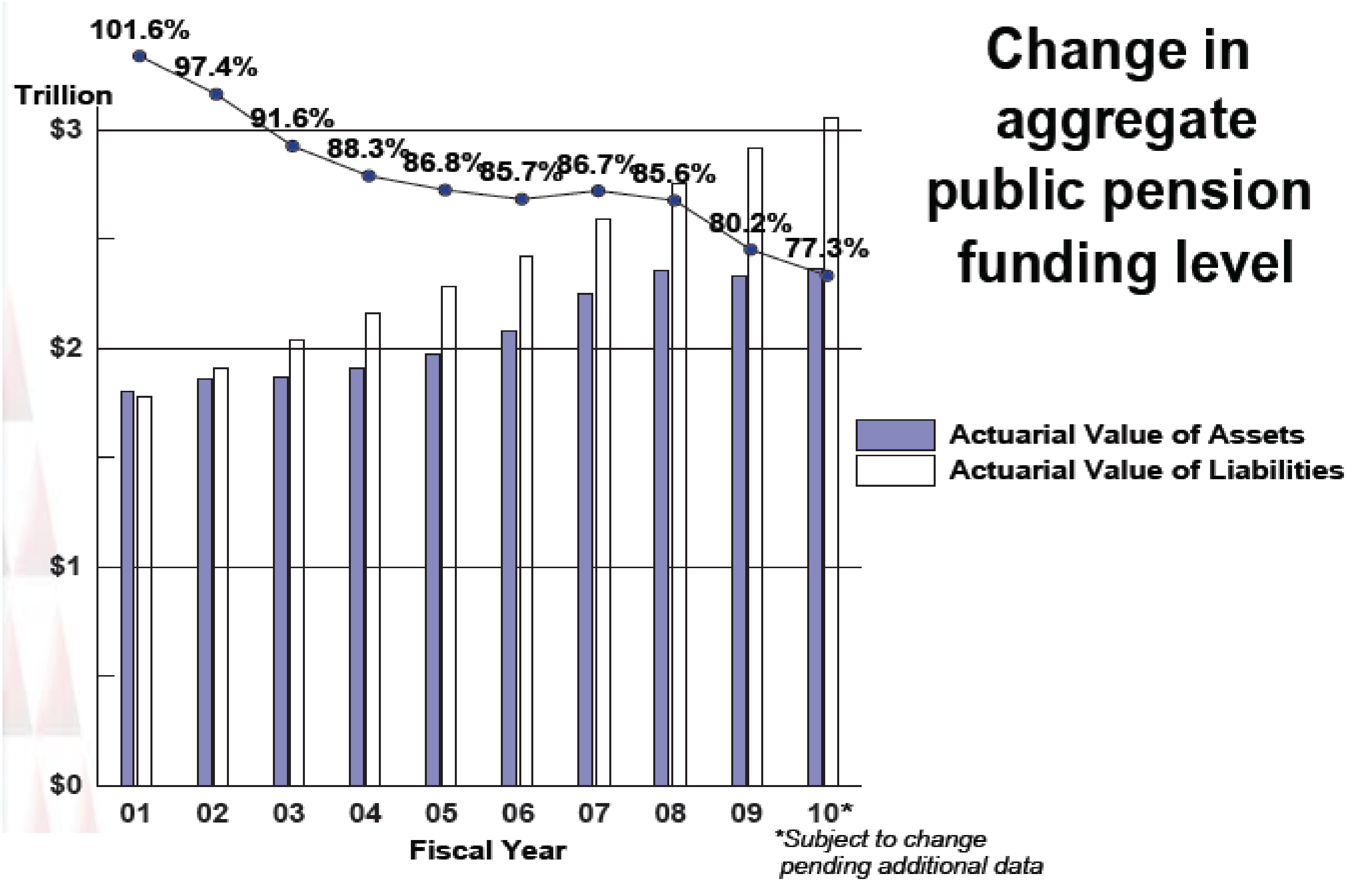
Source: A Better Bang for the Buck, NIRS, 2008

Public Pensions: Strong Financials for Most Plans Going into Financial Crisis



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Source: NASRA, *The State Landscape on Pensions*, 2011

Lessons Learned Study

1. Employer pension contributions that pay the full ARC, and that at least equal the normal cost;
2. Employee contributions to help share the plan cost;
3. Benefit improvements that are actuarially valued before adoption and properly funded upon adoption;
4. COLAs granted responsibly;
5. Anti-spiking measures that ensure actuarial integrity, transparency;
6. Economic actuarial assumptions that can reasonably be expected to be achieved long term.

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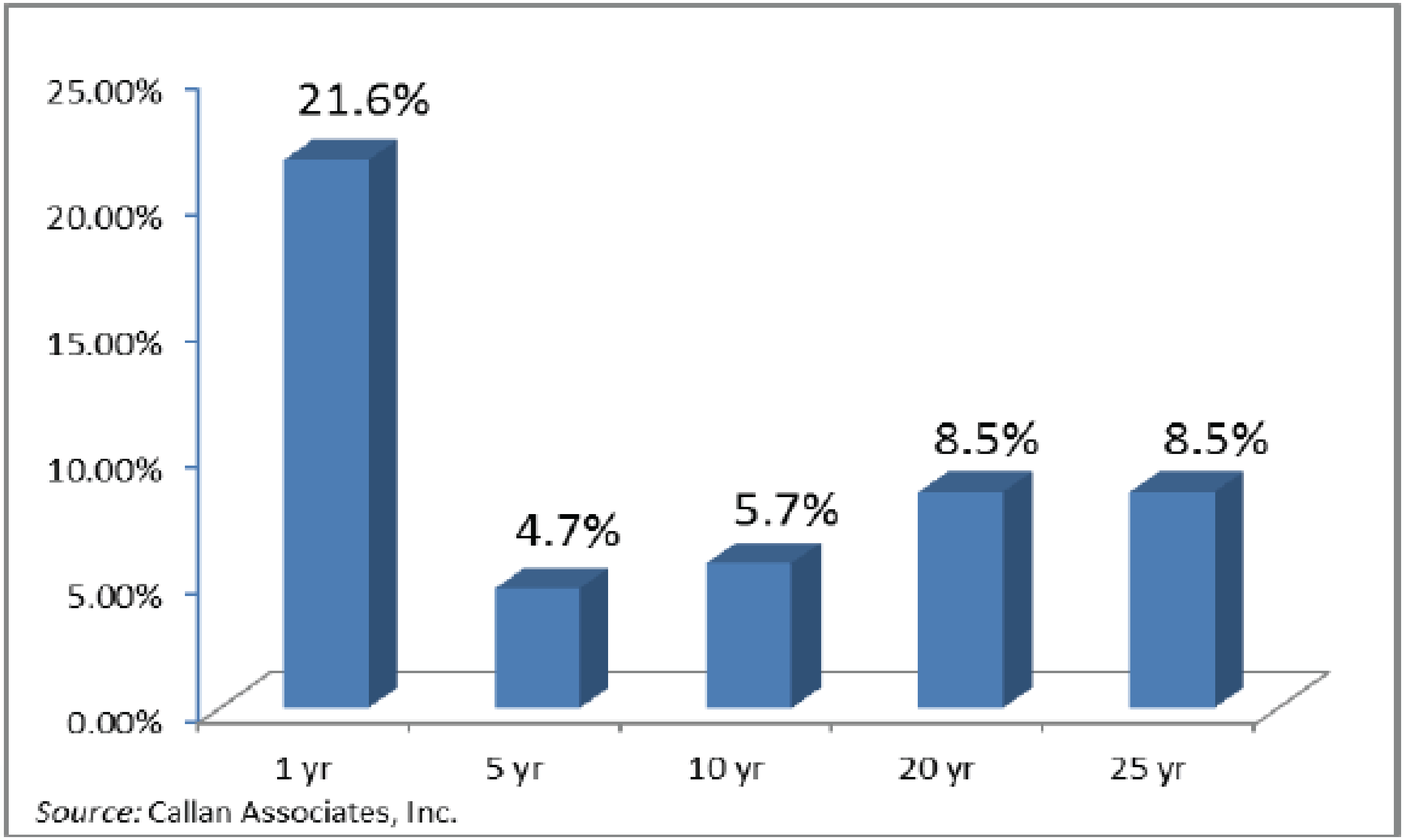
Median Public Pension Fund Investment Returns for Periods ended June 30, 2011



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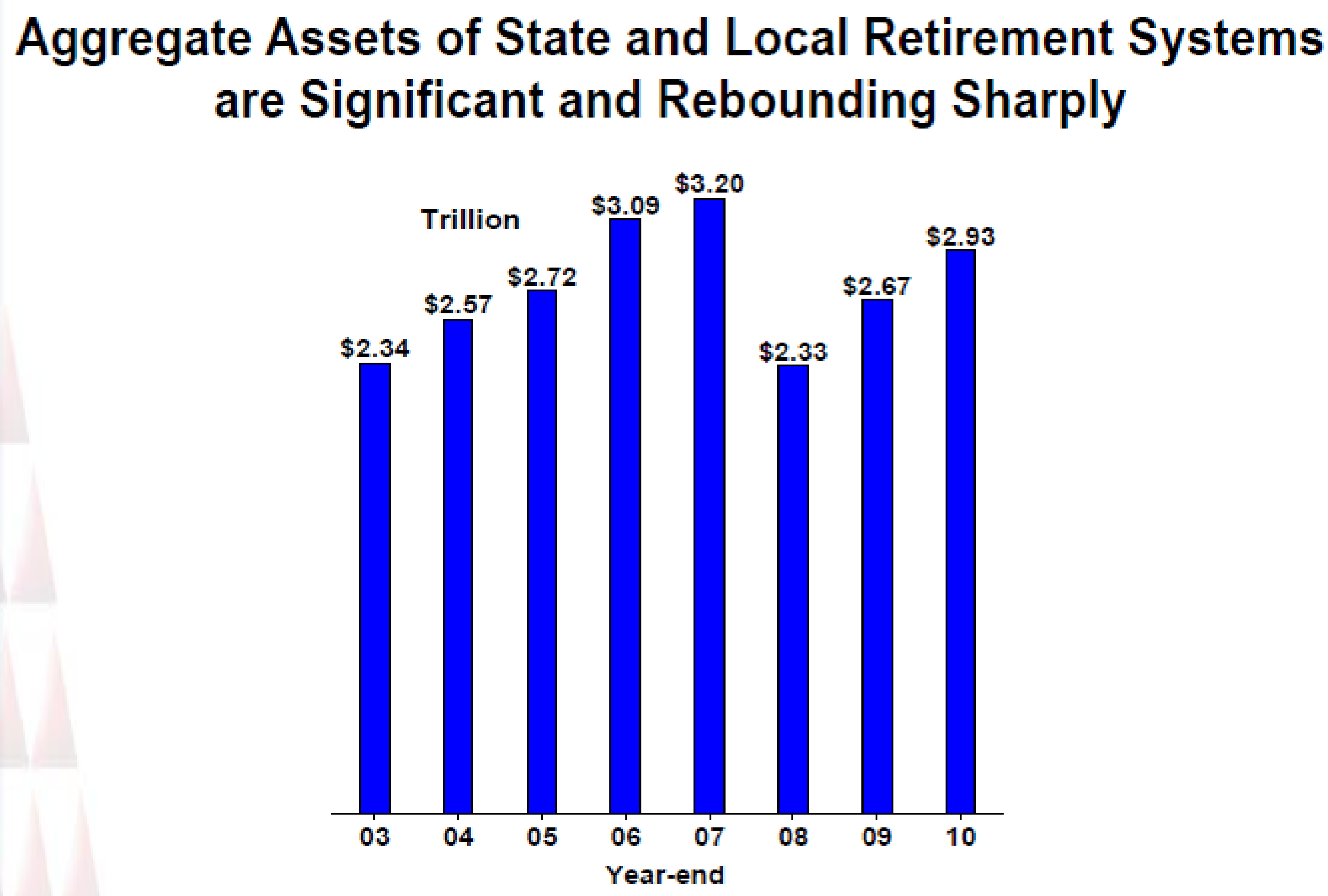
Source: NASRA, *The State Landscape on Pensions*, 2011

Public Pensions Showing Strong Recovery



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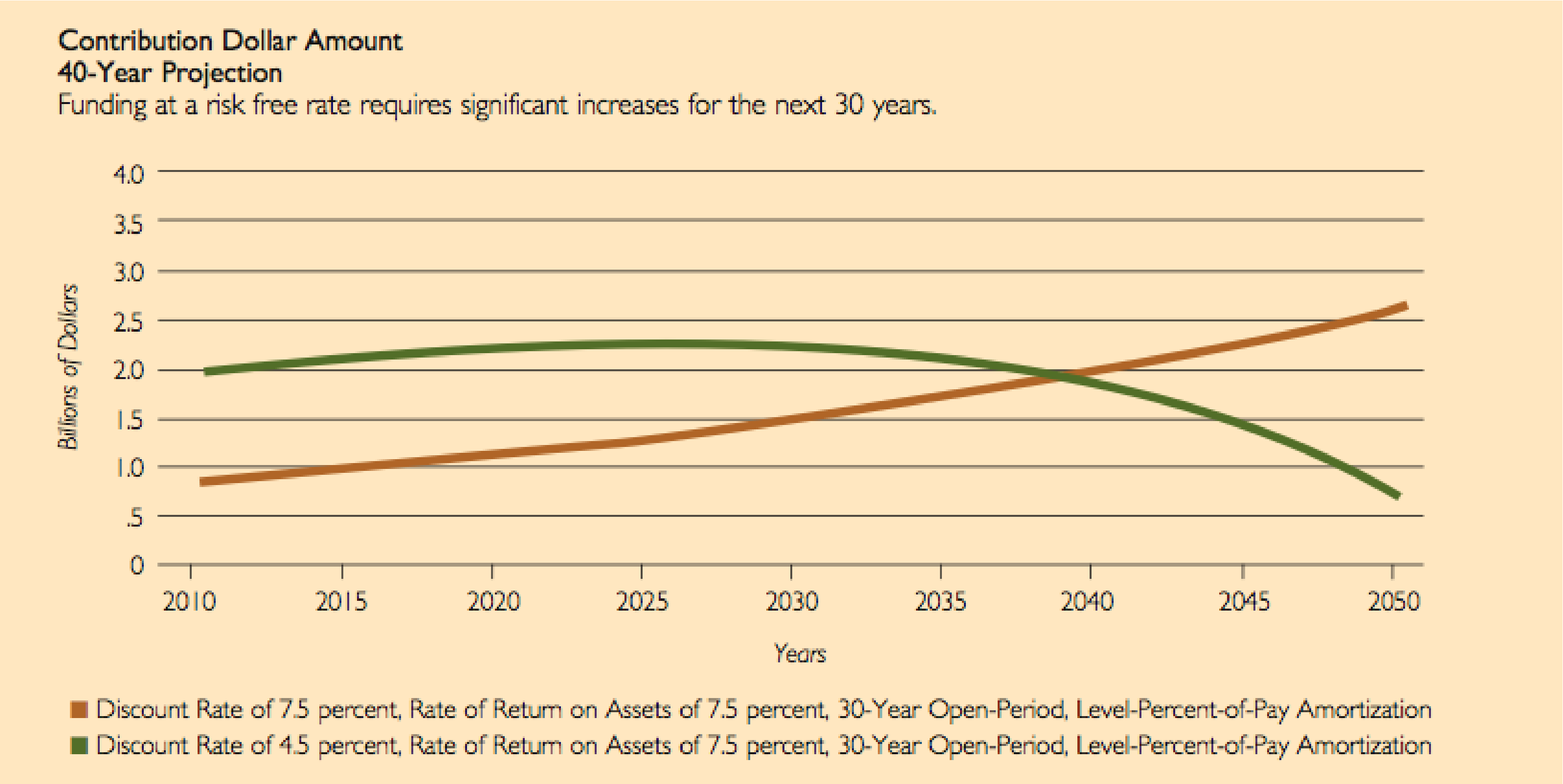
Source: Federal Reserve Flow of Funds

Using Theory Rather Than Reality Artificially Inflates Public Pension Costs

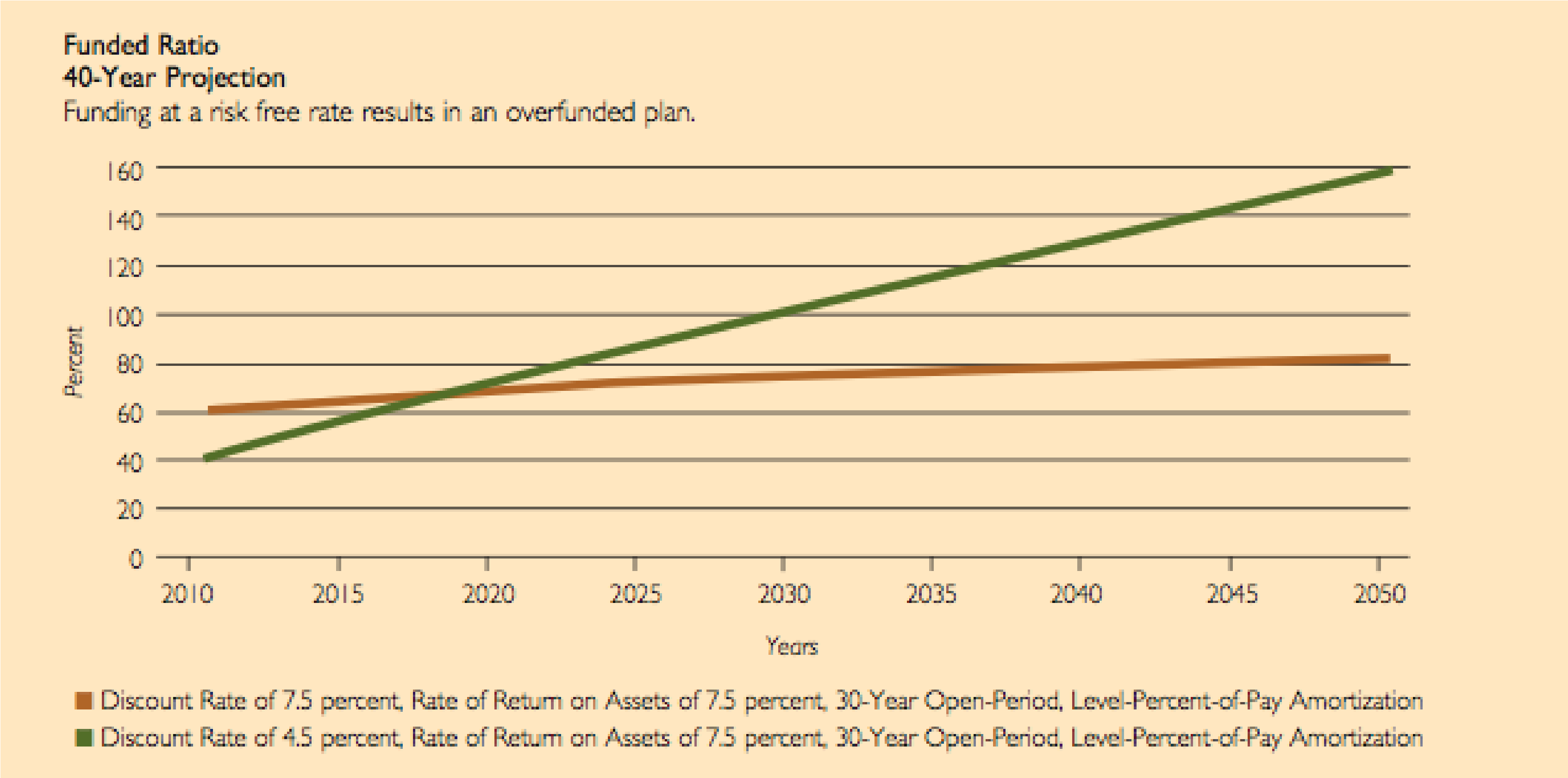
Risk-Free Rate Leads to Increased Costs



Source: Government Finance Review, February 2011

Using Theory Rather Than Reality Artificially Creates Surplus

Risk-Free Rate Leads to Excess Funding



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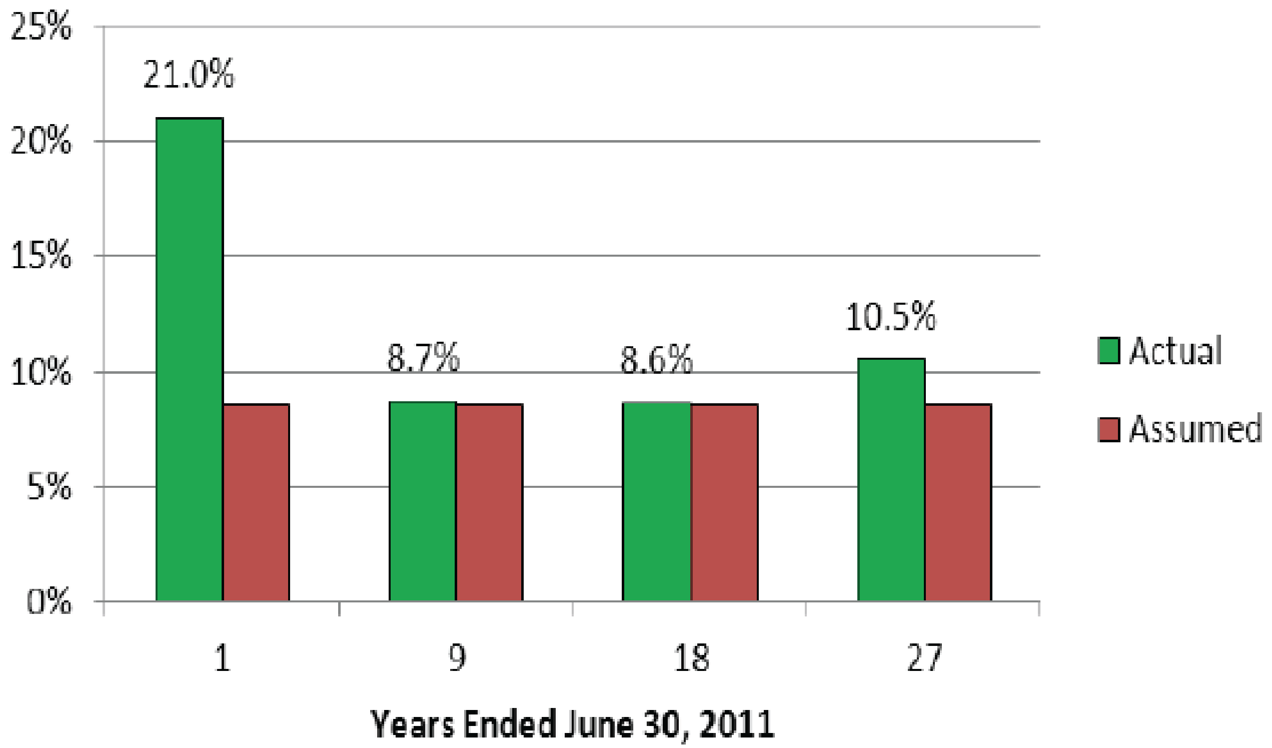
Source: Government Finance Review, February 2011

Timing is Everything (The 9-Year Business Cycle)



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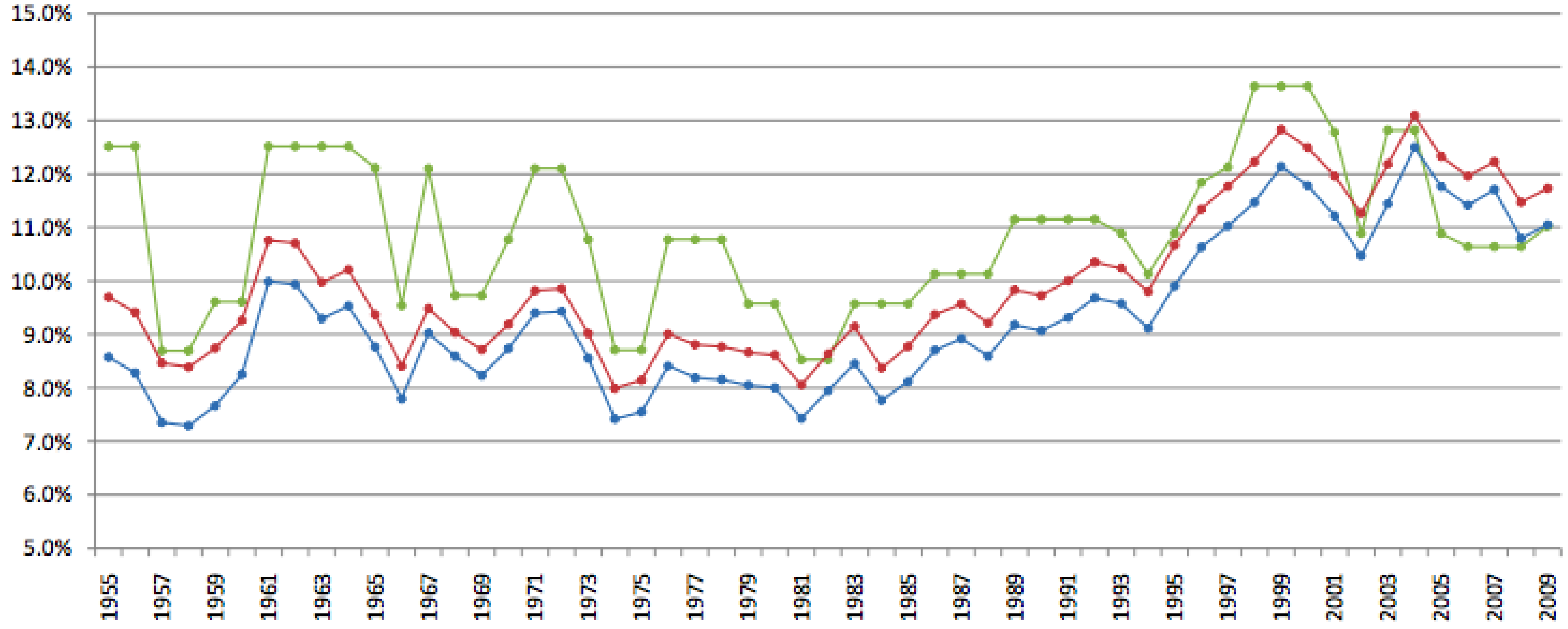
Source: NASRA, *The State Landscape on Pensions*, 2011

Historical Snapshot: Investment Returns

Rates of Return for Rolling 30-Year Periods Ending 12/31
For a Portfolio of 60% Large Co. Stocks and 40% Long Corp. Bonds Per SBBI
(For example, Arith Mean for 1/1/1926 - 12/31/1955 was 9.7%)



Median Return for 30 Years Ending 12/31

Arithmetic Mean for 30 Years Ending 12/31

Geometric Mean for 30 years Ending 12/31

Observations:

1. An 8% long-term expected rate of return so common in the past for typical public sector pension portfolios has NOT been overly optimisitic.

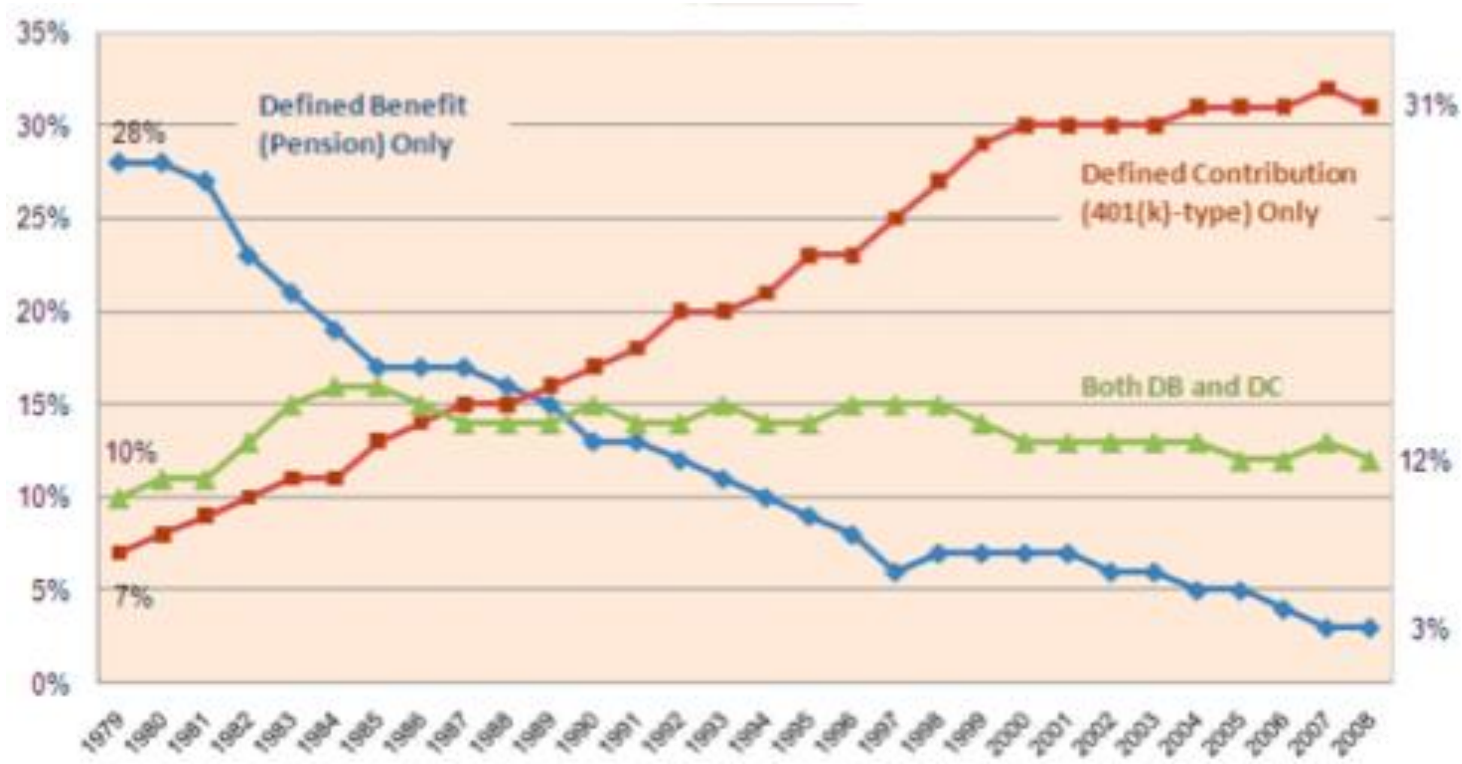
2. The future might look better or might look worse than the past.

3. No one has a crystal ball. All forecasts of future investment returns are opinions, not facts.

Source: Gabriel, Roeder, Smith & Company

Retirement Anxiety: Shift in Pension Coverage

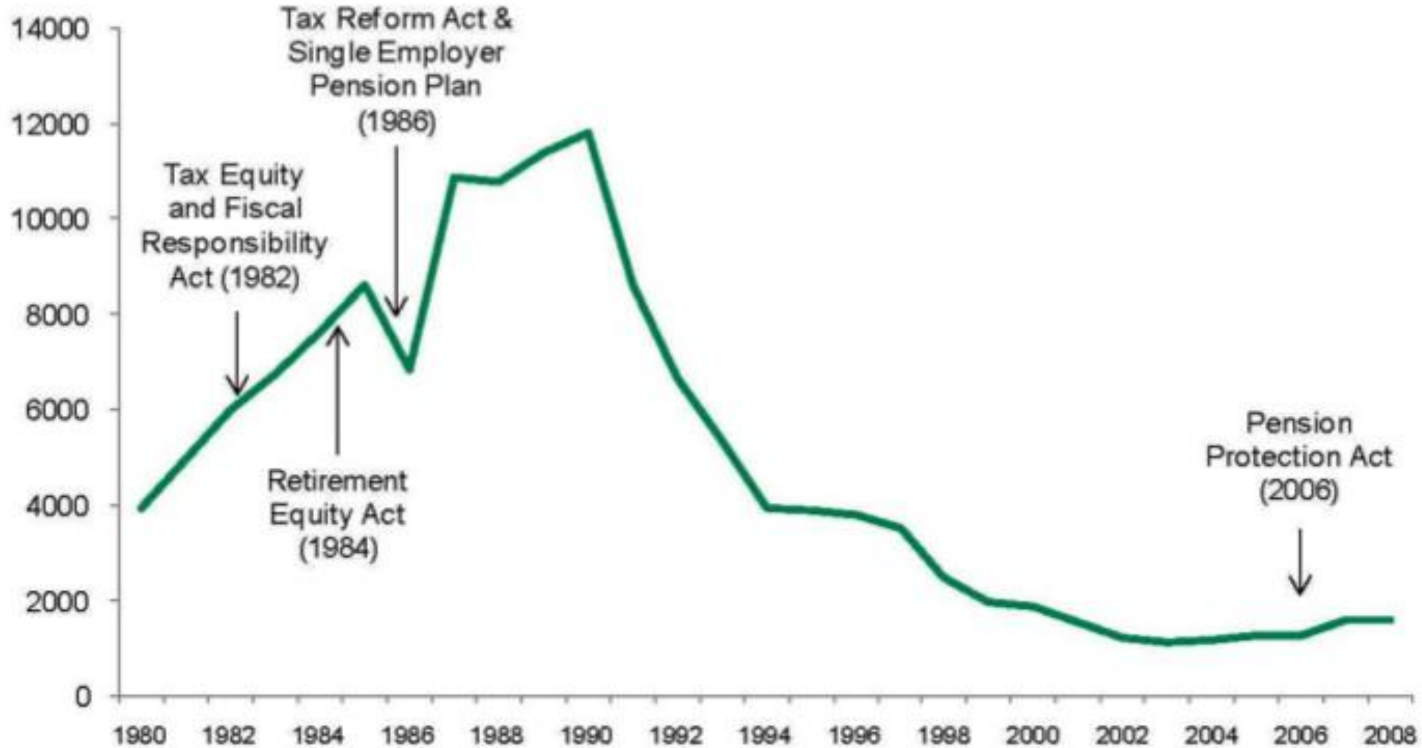
Private Sector Workers Participating in Employer Based Retirement Plan by Plan Type, 1979-2008 (all workers)



Source: New American Foundation, DOL, PBGC, EBRI

Regulations, Funding Volatility Kill Private Sector Pensions - Not Costs

Figure 2. PBGC Standard Single Employer Terminations, 1980-2009

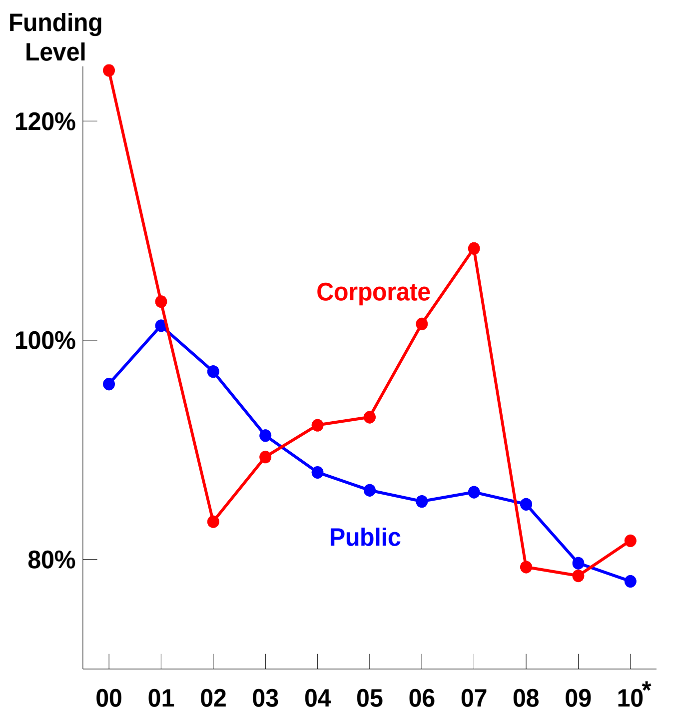


Source: Pension Benefit Guaranty Corporation. 2010. *PBGC Databook 2009*. Washington, DC: PBGC. and Pension Benefit Guaranty Corporation. 2001. *PBGC Databook 2001*. Washington, DC: PBGC.

Regulations, Funding Volatility Kill Private Sector Pensions - Not Costs

Corporate vs. Public Pension Funding Levels, Costs

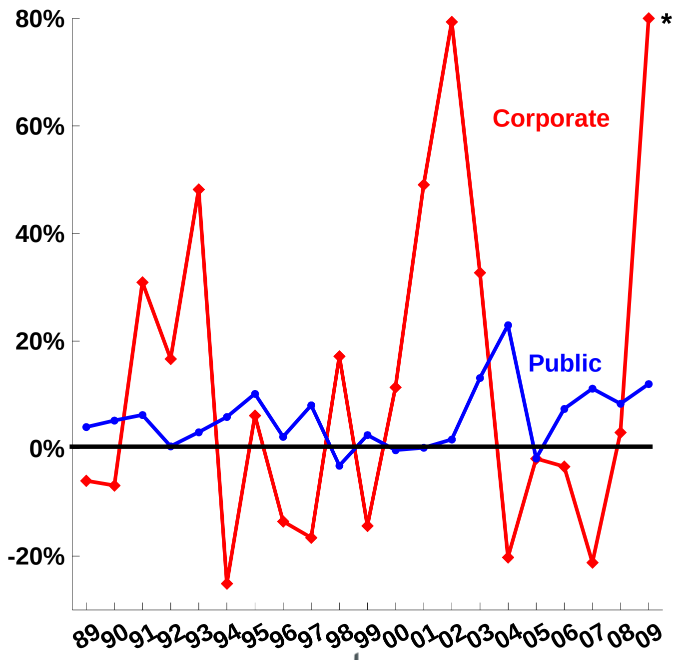
Comparison of corporate and public pension funding levels, 2000 to 2010



Wilshire, Milliman, and Public Fund Survey

*Estimate

Comparison of change from prior year in corporate and public pension contributions, 1989 to 2009



US Dept of Labor, US Census Bureau, Milliman

*Estimate

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Closing an Underfunded Plan Does Not Save Money

- Most states have determined the appropriate response to their pension challenges is to make adjustments to the existing benefit design and financial structure.
- Closing a public pension plan has unintended consequences.

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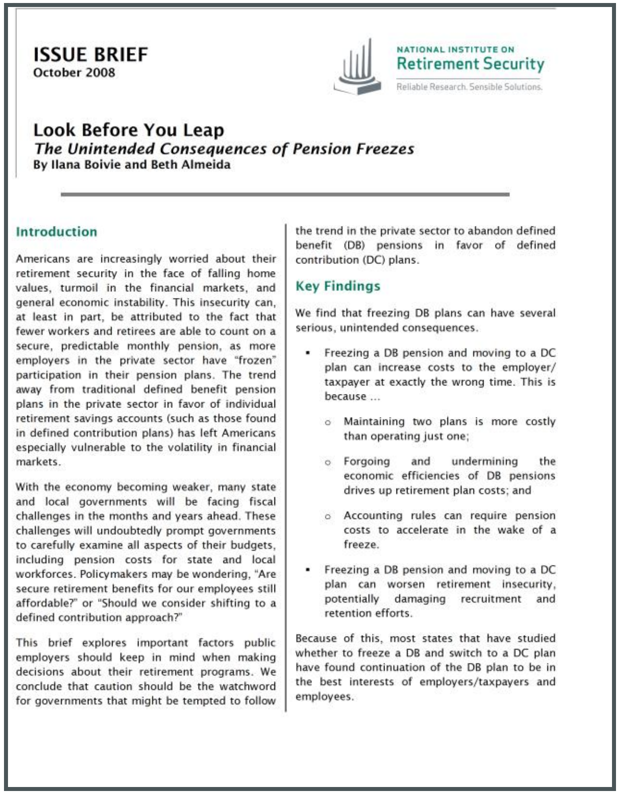
Source: NASRA, *The State Landscape on Pensions*, 2011

DB to DC Switch Not a Viable Solution



ISSUE BRIEF
October 2008

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Look Before You Leap
The Unintended Consequences of Pension Freezes
By Ilana Boivie and Beth Almeida

Introduction

Americans are increasingly worried about their retirement security in the face of falling home values, turmoil in the financial markets, and general economic instability. This insecurity can, at least in part, be attributed to the fact that fewer workers and retirees are able to count on a secure, predictable monthly pension, as more employers in the private sector have "frozen" participation in their pension plans. The trend away from traditional defined benefit pension plans in the private sector in favor of individual retirement savings accounts (such as those found in defined contribution plans) has left Americans especially vulnerable to the volatility in financial markets.

With the economy becoming weaker, many state and local governments will be facing fiscal challenges in the months and years ahead. These challenges will undoubtedly prompt governments to carefully examine all aspects of their budgets, including pension costs for state and local workforces. Policymakers may be wondering, "Are secure retirement benefits for our employees still affordable?" or "Should we consider shifting to a defined contribution approach?"

This brief explores important factors public employers should keep in mind when making decisions about their retirement programs. We conclude that caution should be the watchword for governments that might be tempted to follow the trend in the private sector to abandon defined benefit (DB) pensions in favor of defined contribution (DC) plans.

Key Findings

We find that freezing DB plans can have several serious, unintended consequences.

- Freezing a DB pension and moving to a DC plan can increase costs to the employer/taxpayer at exactly the wrong time. This is because ...
  - Maintaining two plans is more costly than operating just one;
  - Forgoing and undermining the economic efficiencies of DB pensions drives up retirement plan costs; and
  - Accounting rules can require pension costs to accelerate in the wake of a freeze.
- Freezing a DB pension and moving to a DC plan can worsen retirement insecurity, potentially damaging recruitment and retention efforts.

Because of this, most states that have studied whether to freeze a DB and switch to a DC plan have found continuation of the DB plan to be in the best interests of employers/taxpayers and employees.

- By itself, freezing plan does nothing to close and funding shortfalls
- Freezing plan undermines the economics of the plan by starving it of new entrants
- Because of accounting regs, plan costs can actually *increase*
- Undermines retirement readiness

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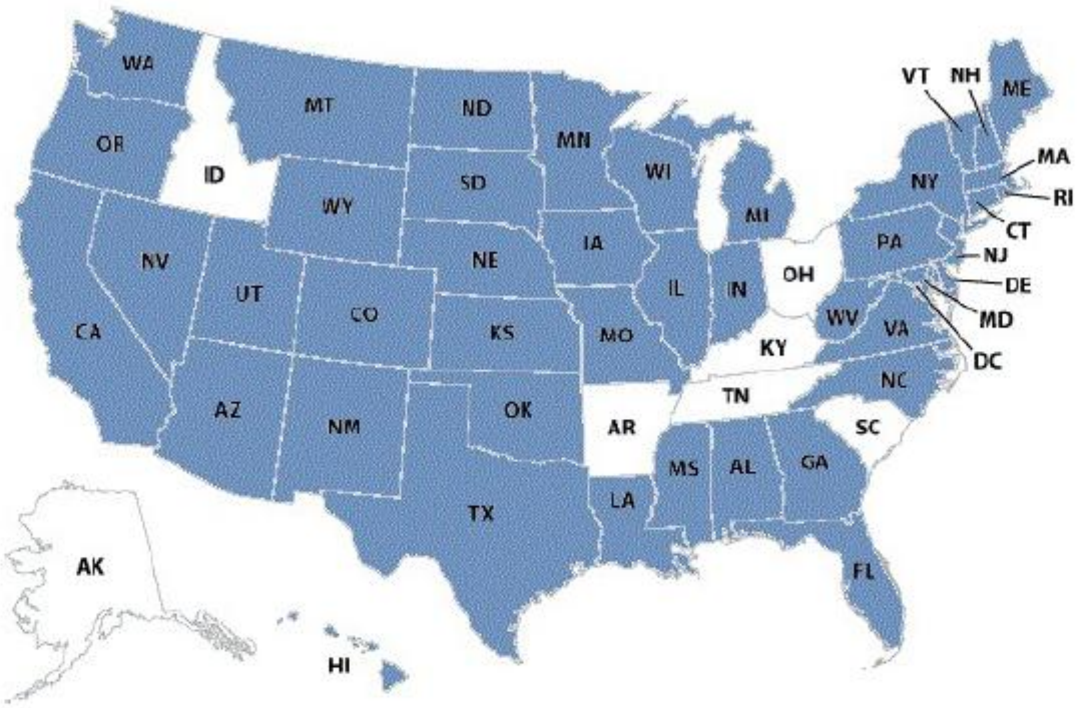
Source: National Institute on Retirement Security, *Look Before You Leap*

How Are States Responding to Higher Pension Cost?

Since 2009, 42 States have made changes to their pension benefits, required employee contributions, or both



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Source: NASRA, *The State Landscape on Pensions*, 2011

Notable and Widespread Changes Continue to be Made at State Retirement Systems

Most common changes(NCSL data) : higher retirement age; more years of service; longer vesting, COLA, higher employee contributions, elimination of employee non-contributory plans

- In 2010, three states (CO, MN, SD) modified COLAs for current retirees
- Ten more states reduced COLA provisions this year
  - Four - MD, NJ, OK, RI – affected existing retired members
- At least 15 states raised employee contribution rates, some affecting existing participants

Other changes:

- Longer final average salary periods, more restrictive return-to-work policies, anti-spiking provisions

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Source: NASRA, *The State Landscape on Pensions*, 2011

Employer Challenges When a DC Plan is the Primary Retirement Benefit

Loss of a human resource management tool

- A pension plan is particularly helpful for retaining qualified workers needed to perform essential public services
- Retention is key for certain groups: teachers, law enforcement personnel, and members of other career oriented groups

A pension plan promotes the human resource management objective of orderly turnover, i.e., retirement, or ability to retire, at an appropriate age.   Orderly turnover facilitates workforce management objectives

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Source: NASRA, *The State Landscape on Pensions*, 2011

Taxpayer Challenges When a DC Plan is the Primary Retirement Benefit

- General loss of retirement security: 12+ percent of the nation's workforce is employed by state or local government and 85% have a pension plan
- Loss of economic benefits emanating from pension payments
- Pensionomics: Each dollar contributed by taxpayers to public pension plans supported over $11 in economic activity in the state
- Public pension funds are owners of some seven percent of the US public equity market and have large holdings in many Texas-based corporations
- Public pension funds account for nearly one-half of the nation's venture capital pool

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Source: NASRA, *The State Landscape on Pensions*, 2011

Employee Challenges When a DC Plan is the Primary Retirement Benefit

•Fees – the cost of a typical defined contribution plan exceeds one percent of assets annually

• Lower investment returns – DC plans underperform professionally managed retirement pools by around one percent annually

• Timing – an employee who retires during a down market will suffer relative to those who retire during an up market

• Longevity risk – a retiree could outlive their assets

• Leakage – assets leaving the retirement account before the account holder reaches retirement age

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Source: NASRA, *The State Landscape on Pensions*, 2011

What has Been the Experience of DC Plans as the Primary Retirement Benefit in the Public Sector?

- Nebraska found that its defined contribution plan for state and county workers was resulting in workers reaching retirement financially unprepared
  - Switched to a cash balance plan in 2003
- West Virginia switched its teachers to a DC plan in 1993, then back to the pension plan in 2005
  - Experience with a DC plan went badly
- Michigan state workers hired since 1997 have only a DC plan
  - DB plan costs have risen to 17 percent of pay to amortize the UAL
  - The state is saving solely due to low participation in the new DC plan
- Alaska closed its pensions to all new hires in 2006
  - DB plan costs have risen sharply since

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Source: NASRA, *The State Landscape on Pensions*, 2011

Hybrid Retirement Plans

- Cash Balance
  - Nebraska state and county workers
  - Texas municipal and county & district plans
- Combination "DB+DC" plans, featuring a reduced DB component combined with a DC plan
  - Georgia
  - Indiana
  - Michigan
  - Ohio
  - Oregon
  - Utah
  - Washington

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Source: NASRA, *The State Landscape on Pensions*, 2011

Opportunities and Challenges

Challenges:

- Distinguishing assertions from facts
- Legislation by anecdote/knee-jerk reactions
- Short sighted policies that encourage a “race to the bottom”

Opportunities:

- Better understanding of long-term nature of state/local government pension financing
- Appreciation of core elements of public pension design that are the most cost-effective way to accomplish human resource and retirement security policies

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Source: NASRA, *The State Landscape on Pensions*, 2011

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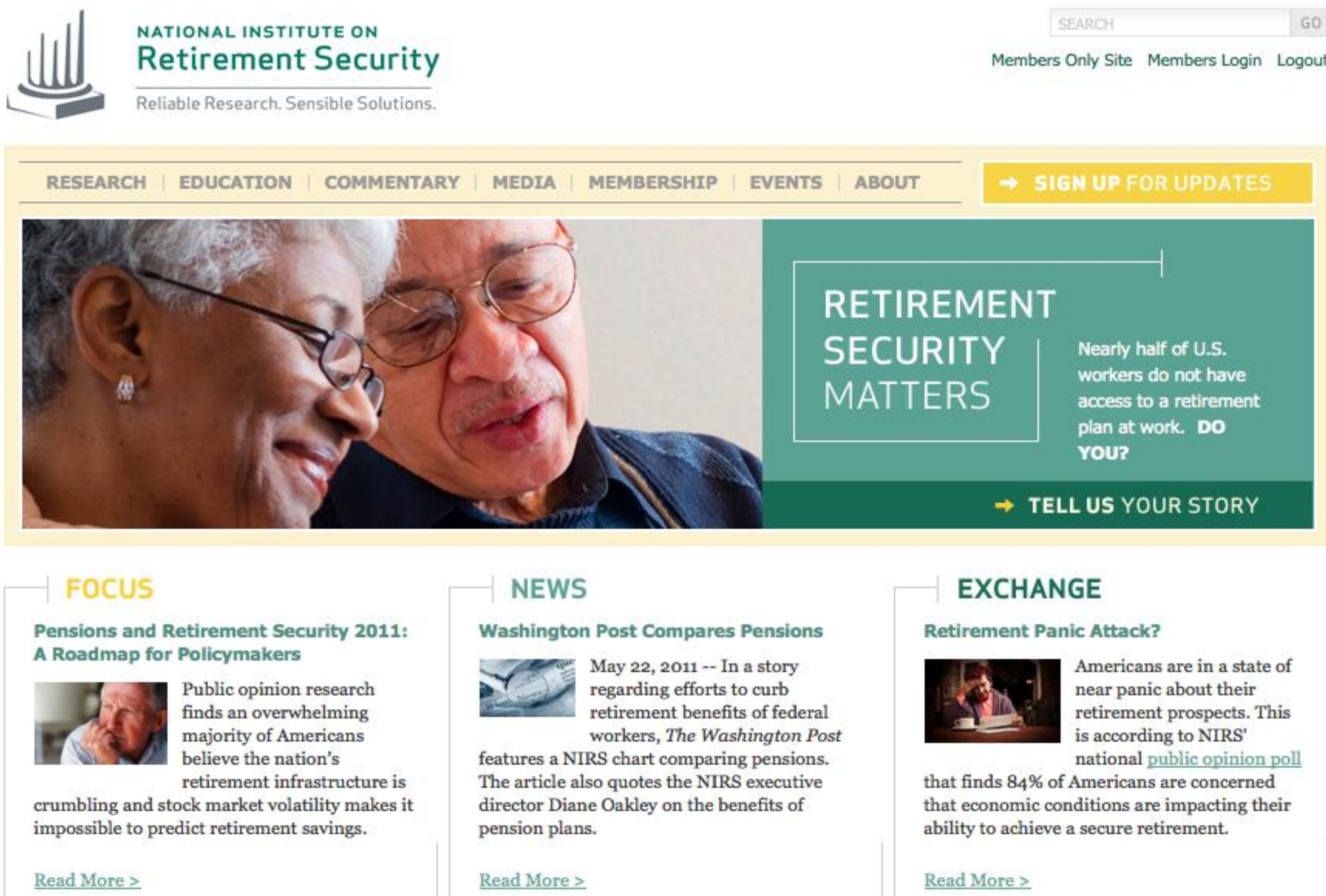

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