

Fiscally Sustainable Retirement Plan Design



GFOA CONFERENCE

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Buzz around town...



- Can public pension plans be sustained?
- Are DC structures the better bet today?
- Are public fund investments being mismanaged?
- Are public funds telling the truth about their current situation?

Today we'll discuss:



- Value of pension plans
- Overview of current situation
- Path leading to current situation
- Potential changes to pension systems
- Future changes which could impact systems

Are pension plans bad?



Even though pension plans have recently hit a market downturn, they are the most economical way to provide reliable retirement security.

Are pension plans bad? (cont'd)



- Lifetime Benefits – guaranteed income
- Employer/Employee shared responsibility
- Survivor and disability protections
- \$3 trillion in public pension plan assets
- For some, no social security
- Leave large economic footprint

Pension Plans' Economic Footprint



- Plans pay out \$165 billion annually to 7.5 million people
- \$358 billion in economic output
- \$57 billion in federal, state and local tax revenue
- Lower poverty levels potentially save \$73 billion for taxpayers
- Poverty levels for elderly with pension:
 - 82% not poor
 - 16% near poor
- Poverty levels for elderly without pension:
 - 51% not poor
 - 34% near poor

Where are we?



- \$1 trillion gap
- Average Funding Ratios have declined from 85% in 2006 to 70% in 2009
 - 10 states have over 33% unfunded liabilities
- State ARCs increasing 2% or more in coming years
 - 21 states did not fund 90% of their ARC over the past five years
- Average investment returns getting better
 - 2008 (18.9)%
 - 2009 19.5%

Where are we? (cont'd)



- **State pension plans rated by PEW**
 - 16 states – solid performers
 - 15 states – need improvement
 - 19 states – serious concerns
- **State budgetary problems**
 - Pension plan funding causing Bond Rating issues

So, how did we get here?



How did we get here?



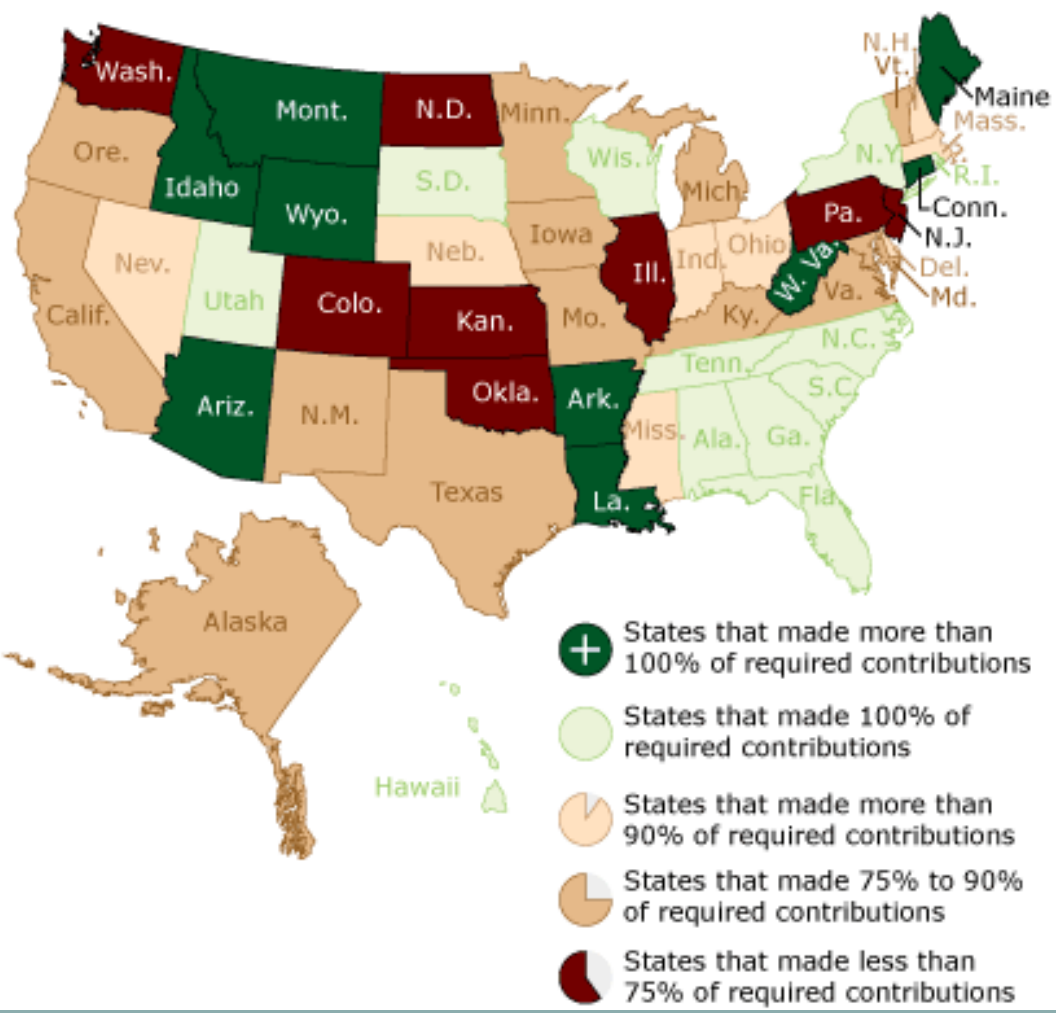
- **Contractual obligations**
 - Public pension plans are often protected by statute or state constitution
- **Short-term policy decisions with long-term impacts**
 - Legislators generally have been willing to give up a benefit today for a theoretical costs savings today
 - Straddle Option – assets go up, benefits increase; assets go down, taxpayers pay more

How did we get here? (cont'd)



- **Abuses in government/Inability to control**
 - Pension spiking
 - Double dipping
 - Disability approvals
- **Market downturn**
 - Assumed rates of return of 7-8%
 - Actual average 2 year loss of 24%
- **Actuarial assumptions**

ARC Funding





The pendulum always swings a little too far. Pension plan design doesn't have to be an all or nothing proposition.

Turning the wheel slightly can right the ship miles ahead.

What can we do?



- Focus on long-term solutions, not Band-Aids
- Adequate funding today minimizes tomorrow's liabilities
- Correct – not cover up – past mistakes
- Abuses should be eliminated, no matter how limited in number

Potential Plan Design Changes



- **Change 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 contribution**
 - State of Utah new design (minimizes future state contributions)

Actuarial Analysis



- Is the problem the actuarial model?
- Should discount rates be changed?
- Should we be utilizing expected rate of investment return or risk free discount rate?

Controversy Over the Actuarial Model



- Actuarial model versus financial economics
- Actuarial model basics
 - Develops a funding policy designed to accumulated assets to pay benefits
 - Incorporates anticipated return on investments
- Financial economics basics
 - Need to discount guaranteed promises at risk free rate
 - Tends to produce higher costs than actuarial model

Example of Actuarial Model



- Consider your own personal savings for retirement
- Make assumptions; for example:
 - You'll earn 8%
 - You'll retire at 65
 - You'll live to 85
 - Your pay will grow by 4% per year
 - Inflation will be 3%
 - You'll need enough to withdraw 80% of final pay
- Do the math
 - Figure out how much you need to save
 - Adjust each year based on errors in assumptions

Example of Financial Economics Approach



- **Consider what benefit is accrued in any given year**
 - For example, 2% of pay for each year of past service, payable for life beginning at age 60
 - How much money is required to meet that obligation, discounted at risk free rates
- **This is the amount which must be in fund**
 - No smoothing of deviation
 - Encourages investing in bonds

What can impact plans in the future?



The picture can change quickly – impacting both state funding and plans.

Future Impacts



- GASB Standards
- SEC Oversight
- IRS Oversight

Accounting Standards



- Quick overview of GASB standards
- GASB Postemployment Benefits (PEB) project
- Likely outcomes of PEB
 - Ambiguous Required Contribution
 - Larger balance sheet liability
 - Volatility
 - Faster amortizations
- Implications and potential changes

What are the GASB standards?



- Government Accounting Standards Board
- Rules for reporting and disclosure
 - Of pension funds (GASB 25)
 - Of pension fund sponsors (GASB 27)
- Current disclosures:
 - “Actuarial Required Contribution” (ARC)
 - Funded levels
 - Shortfall or excess of actual funding vs. ARC (NPO)
- Many systems use ARC as what “should be” funded

GASB PEB Project



- GASB 25/27/43/45
- Research project
- Task Force
- Invitation to Comment (ITC)
- Staff Issue Papers
- Board Meetings/Tentative decisions
- “Due Process Document” (Preliminary views)
- Exposure Draft
- Final Standard

Likely Outcomes of PEB Project



- Expense (ARC) may no longer be viable funding bogey
- Emphasis will shift from NPO to Unfunded Liability (UL)
- More volatility
- Possible shift from expected return on plan assets to bond rate

Shift Away from ARC



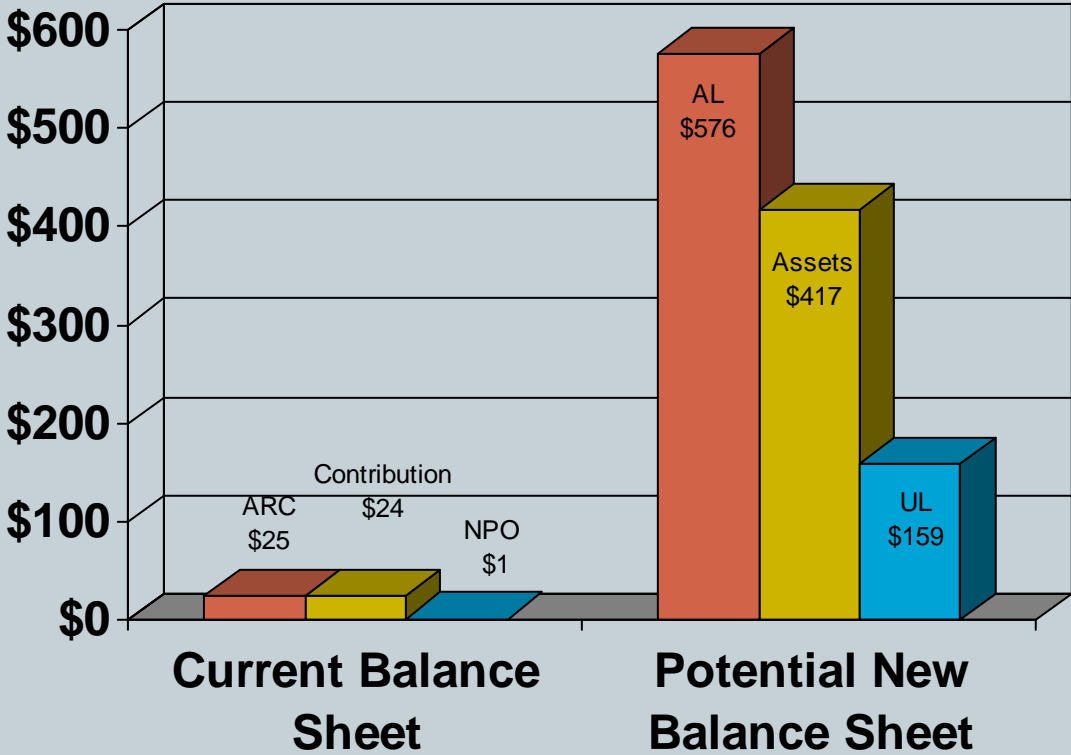
- New pension expense item will be more volatile
- More rapid recognition of many items
 - Plan changes
 - Unexpected investment returns & losses
 - Other actuarial gains/losses and assumption changes
- Employers won't be able to fund these new numbers
- Funds will need to develop their own funding policy (ARC)

Shift from NPO to UL



- NPO is cumulative shortfall of actual funding vs. ARC
- UL is unfunded liability
 - Total Actuarial Liability (AL) minus
 - Actuarial Value of Assets
- Balance sheets will be showing much larger number

Illustration of Shift from NPO to UL



New Types of Volatility



- Asset fluctuations
- Limited asset smoothing
- Change in bond rates?
- Shorter (or no) amortization period
- Changes in actuarial assumptions
- Other actuarial gains & losses
 - Salaries
 - Turnover
 - Mortality

Possible Shift to Bond Rates



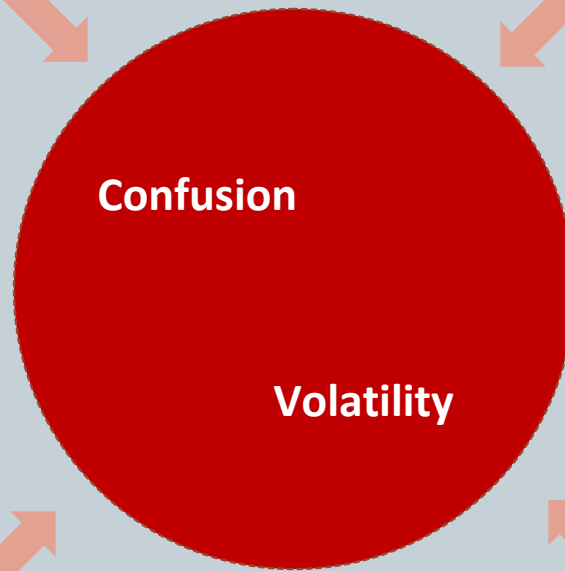
- Current standard focuses on anticipated returns
- Proposed standard may use bond-based discount rates
 - Consistent with some financial economic theory
 - Creates much more volatility
 - Increases reported liabilities in current economic environment

How can government respond?



**Increased Balance
Sheet Liability**

**Ambiguous
ARC**



**Faster
Amortizations**

**Interest
Rate
Volatility**

Conclusions - GASB



- GASB Preliminary Views Document likely in June
- Disconnect between ARC and funding
 - Systems won't be able to rely on GASB standard to get funding
- Large balance sheet liability
- More volatility
- Expect funds to be more controversial
 - Just like when GASB 43/45 were issued

Conclusions



- Plan funding has weakened
- Government budgets are tight
- Pensions are being changed
- Pensions are an efficient way to deliver retirement benefits
- GASB will change

Cobb County Government Employees' Pension Plan

Fiscally Sustainable OPEB Plan Designs

J. Virgil Moon, CPA
Chairman, Board of Trustees

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Background

- **Prior to changes (2007) Cobb County Retirees received the same Healthcare benefit as current employees at the same cost**
 - **Cobb County Paid Average**
 - **90% of Single Coverage**
 - **85% of Family Coverage**
- **Unsustainable for the Long Term**

Background—Continued

- **In 2006, raised premiums 30% to all current and retired employees**
- **Setting aside extra dollars to create OPEB Trust fund**
- **Increased to 20 years from 15 years for new hires to qualify**

Retiree Healthcare Plan

- In 2007, due to new governmental accounting regulations (GASB 43/45), Cobb County created a trust for the Retiree Healthcare Plan
- Increased to 15 years from 10 years to qualify for existing non-vested employees
- Vested employees remained at 10 years

Retiree Healthcare Plan

- **As with the Pension plan, the Board of Trustees worked with actuarial, investment and legal advisors over a 5 month period and reviewed various recommendations to make certain our new plan would remain fiscally sound and affordable for the long term**

Recommendations: Healthcare Plan

- **Effective 1/1/2009 all new hires must work 30 years to receive retiree healthcare benefits**

Recommendations: Healthcare Plan

Continued

- Effective 1/1/2010, Cobb County will contribute 2.5 percent of the health premium cost for each year of service up to a maximum of 30 years of service (75 percent).
 - For example: If a current employee worked for the County for 20 years, Cobb would pay 50% (20 years x 2.5%) of their health premium when they retire.

It is important to note that employees currently retired and employees eligible to retire with a minimum of 10 years of service effective 1/1/2010 are not impacted by the changes above.

Going Forward

- **Approve Recommendations**
- **Continue**
 - **Innovative Education**
 - **Human Resources**
 - **Pension Fund and Retiree Healthcare Web Page**
 - **ICMA Retirement Corporation**

Going Forward

- **Continue**
 - **Active Asset/Liability Management**
 - **Asset Diversification**
 - **Manager Performance Standards**
 - **Pension Fund and Retiree Health Plan Liability Impact Statements on All Major Salary/Health Benefit Changes (\$2,000,000 Biennial cost or more)**

Going Forward

➤ Continue

- **Active Asset/Liability Management**
 - Experience study every 3 years
 - Independent audit of actuarial valuation every 5 years

➤ Continue

- **Employer/Employee Contribution Partnership**

In Closing

We realize that our most important asset is our hard working and dedicated employees.

Thus, we recommended changes that were projected to make our Retiree Healthcare plan fiscally sound and ensure that our employees will have access to these benefits when they retire.

Questions/Answers

