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ECONOMIC FORUM

Commonwealth Foundation
for PUBLIC POLICY ALTERNATIVES

Pensions & Politics
Why Your Taxes Will Skyrocket

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Principles in Practice

"In any conflict between two groups who hold the same basic principles, it is the more consistent one who wins."

"In any collaboration between two groups who hold different basic principles, it is the more … irrational one who wins."

"When opposite basic principles are clearly and openly defined, it works to the advantage of the rational side; when they are not clearly defined, but are hidden or evaded, it works to the advantage of the irrational side."

Source: "the Anatomy of Compromise," *Capitalism: The Unknown Ideal*, p. 145

Overview

- Background: Research & Experience
- Public Pension Primer: Design & Funding
- Pensions Half-Truths
- Principles for Pension Reform

Managing Pension Liabilities

THE WALL STREET JOURNAL

The Public Pension Crisis August 18, 2006; Page A14

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

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

Sources of Pension Problems

- Poor Benchmarking
- Non-Existent Metrics & Unmanaged Risks
- Politics

Poor Benchmarking

- Pennsylvania public pay and benefits are typically benchmarked only against other public plans rather than the entire marketplace
- This fosters “financial relativity”
- Affordability and market trends in the private sector are directly relevant to the public sector

#1 Poor Benchmarking

- Market trends suggest an annual net employer cost of 5% to 7% of payroll is needed to achieve sustainable long-term affordability.

Thirty-One Pennsylvania Companies Participating in the 2009 Hewitt Annual Salaried Benefit Survey

Air Products	Duquesne Light	Penn National
Allegheny Energy	Federated Investors	PNC Financial Services
Armstrong Wood Products	Giant Eagle	Rohm and Haas
Armstrong World	GlaxoSmithKline	Toll Brothers
Black Box Network Services	Heinz	Unisys
Carpenter Technology	Hershey Company	United States Steel
CertainTeed	IKON Office Solutions	UPMC
CIGNA	IMS Health	US Filter
Comcast	Knoll	Voith Siemens Hydro Power
Delaware Investments	Lincoln Financial Group	Westinghouse Electric
	NOVA Chemicals	

#1 Poor Benchmarking

Survey Results

- Only 11 of 31 companies (35%) sponsor Defined-Benefit (DB) plans for new hires
  - Among the 765 companies nationally, the result is 37%

- All 31 companies had Defined-Contribution (DC) plans with an average employer match of $.70 matching an average of 6.1% of payroll
  - Nationally, the results are $.79 and 5.6%

- Why the transition?
  - The inability of companies to achieve pension costs that are current, predictable and affordable
  - Unaffordable retiree medical liabilities

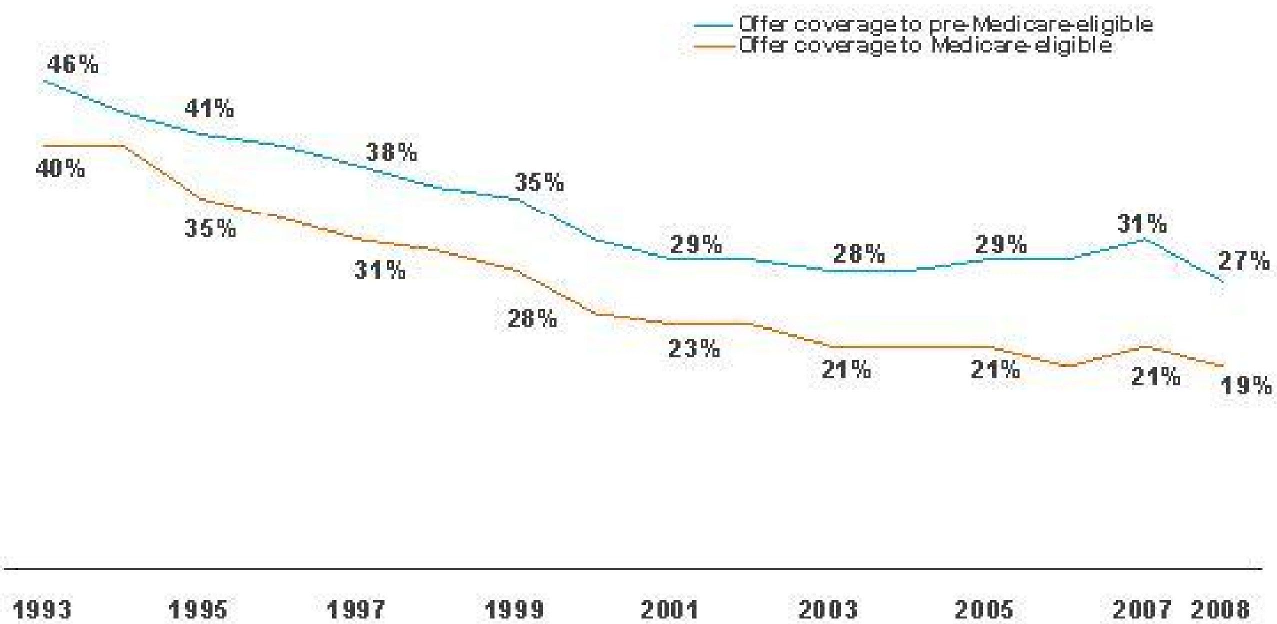
#1 Poor Benchmarking

Trends in the Marketplace (Mercer 2008 - *National Survey of Employer-Sponsored Health Plans, ~3,000 employers*)

FIGURE 7

Offerings of retiree medical plans* have fallen sharply over the past decade

Percentage of large employers



*Plan must be offered on an ongoing basis (i.e., new hires are eligible).

Source: Mercer's National Survey of Employer-Sponsored Health Plans

#2 Non-Existent Metrics & Unmanaged Risks

- No absolute metrics defining the affordability or reasonableness of costs given the "perpetual life of the government entity"
- Creates unreasonable risks to taxpayers
- Actuarial assumptions do not create certainty
- Little consistency in funding assumptions and funding methods making comparisons most difficult

#3 Politics

Pensions as political capital

- Pension Fund **Surplus** = Benefit Improvements for Participants

- Pension Fund **Deficits** = Underfunding by Taxpayers

- Maintaining or Improving Benefits = **High** Political Rate of Return

- Fully and Properly Funding Plans = **Low** Political Rate of Return

#3 Politics

Pensions are not well understood

- Abundance of half-truths
- Benefit commitments can be over 50 years
- Funding is easily manipulated
  - Easy to (re)defer costs to the next generation
- Local and city pension shortfalls are becoming political problems for the state
  - Philadelphia, Pittsburgh and Allentown

Basics of Pension Funding

- Pensions should be funded as benefits are earned
  - In the aggregate, obligations should be "paid up" when members retire

- Employer pension contributions (net of employee contributions)
  - Recurring annual premiums, or the "normal cost"
  - Annual amortization payments

- Calculation of Unfunded Liabilities
  - The periodic measurement of assets versus accrued liabilities

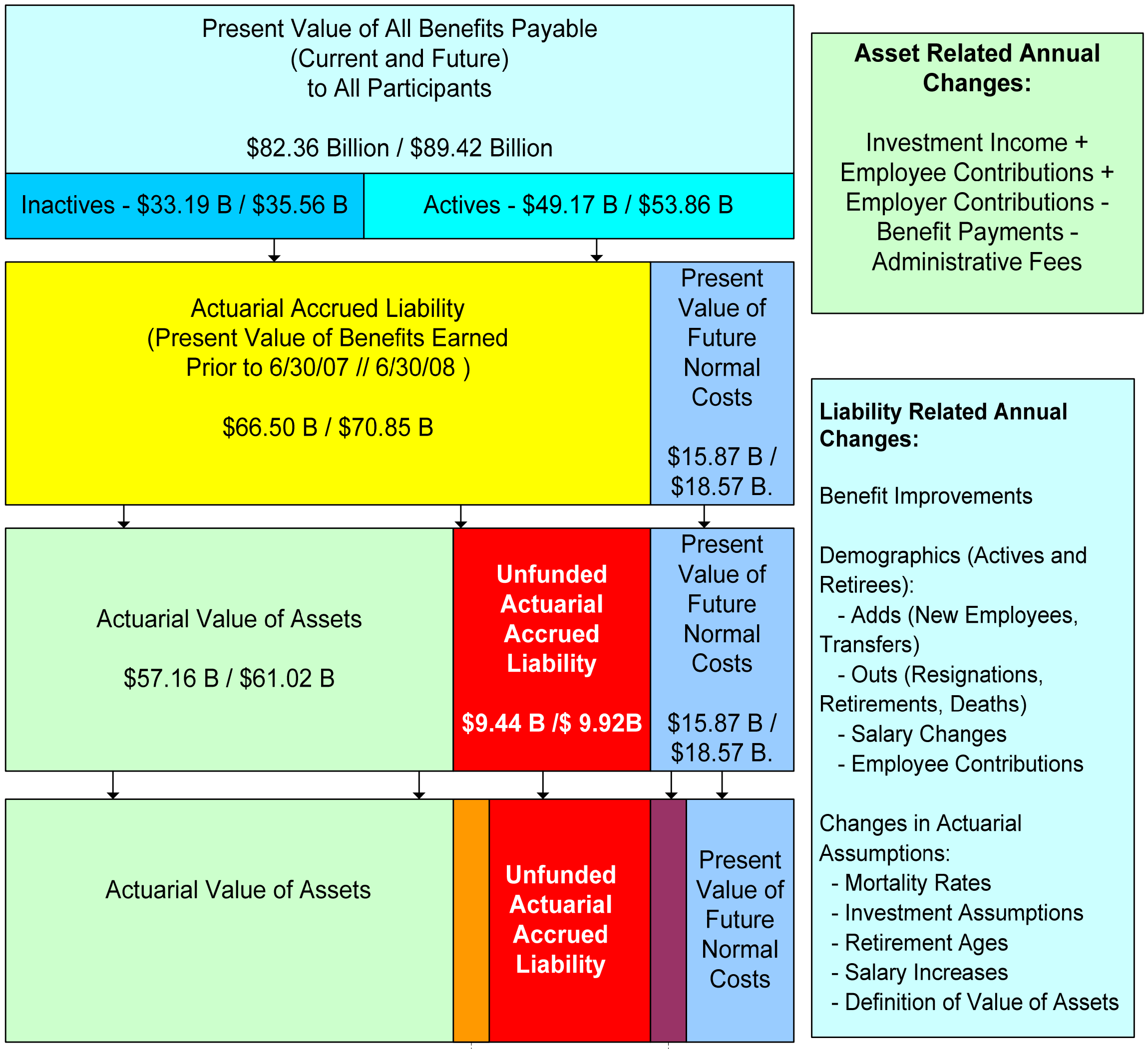
Basics of Pension Funding

- Calculation of Unfunded Liabilities (continued…)
  - Unfunded liabilities/surpluses are spread or amortized like a mortgage
  - Amortization payments result from:
    - Experience (gains and losses)
    - Benefit changes
    - Changes in assumption and funding methods

- Amortization Periods – The concept of the remaining working career
  - If the average age of the workforce is 45 and retirements are assumed to occur at age 60 – then the amortization periods should not exceed 15 years

ACTUARIAL PRIMER - PSERS

Based on JUNE 30, 2007 / JUNE 30, 2008 Actuarial Valuations



	FY 2008-09	FY 2009-10
Annual Payment ("Normal Cost") +	**6.68%**	**7.35%**
Annual Amortization Payments +	**(3.37%)**	**(3.72%)**
=Total Employer Pension Rate (Subject to a 4% Minimum)	**4.00%**	**4.00%**
+Health Insurance	**.76%**	**.78%**
= Total Overall Employer Pension Rate (7/1/08)	**4.76%**	**4.78%**

SUMMARY OF SOURCES OF EMPLOYER CONTRIBUTION RATE
AS OF JUNE 30, 2008
($ Amounts in Thousands)

	Funding Period (Years)	Beginning July 1	Initial Liability	7/1/2008 Outstanding Balance	Annual Payment Amount	Annual Payment Percent *
1. Amortization of:						
a) 2001 Fresh Start Unfunded Base	10	2002	$ (9,137,130)	$ (4,949,221)	$ (1,504,168)	(11.66)%
b) 2001 Asset Method Change (Act 38)	10	2002	(4,638,306)	(2,512,387)	(763,565)	(5.92)%
c) Other 2001 Changes	30	2002	7,570,507	6,750,658	654,914	5.08 %
d) 2002 Changes	30	2003	3,014,171	2,928,010	280,308	2.17 %
e) 2002 COLA	10	2003	463,795	302,225	76,271	0.59 %
f) 2003 COLA	10	2004	754,524	616,444	134,491	1.04 %
g) 2003 Changes	30	2004	3,229,593	3,376,048	319,304	2.48 %
h) 2004 Changes	30	2005	2,903,093	3,067,132	286,891	2.22 %
i) 2005 Changes	30	2006	3,765,745	4,017,250	371,977	2.88 %
j) 2006 Changes	30	2007	812,226	874,170	80,197	0.62 %
k) 2007 Changes	30	2008	(3,870,741)	(4,199,754)	(382,034)	(2.96)%
l) 2008 Changes	30	2009	(347,095)	(347,095)	(34,165)	(0.26)%
Total Amortization Payments				$ 9,923,480	$ (479,579)	(3.72)%
2. Employer Normal Cost Rate						7.35 %
3. Preliminary Pension Rate (1) + (2)						3.63 %
4. Preliminary Pension Rate with 4% Floor – Maximum of (3) and 4%						4.00 %
5. Health Insurance Rate						0.78 %
6. Final Total Employer Contribution Rate Calculated by Actuary (4) + (5)						4.78 %

Understating/Deferring Liabilities

- Higher annual investment assumptions
  - Often 8% or more

- Longer asset averaging periods
  - Up to 5 years often with limits of +/- 30% within the actual market value

- Longer amortization periods
  - Up to 30 years
  - Often using assumed payroll of members yet to join plan
  - Beyond the average working career of the workforce
  - "Fresh starting" (a new 30 year period) when costs become unaffordable

Understating/Deferring Liabilities

- Justification
  - "Perpetual life of the government entity"
  - Acceptance of an 80% funding target
  - Invoking the term "actuarially sound"

THE WALL STREET JOURNAL

Public Pensions Cook the Books July 6, 2009

Some plans want to hide the truth from taxpayers.

"But the National Association of State Retirement Administrators objections seem less against market valuation itself than against the fact that higher reported underfunding "could encourage public sector plan sponsors to abandon their traditional pension plans in lieu of defined contribution plans."

Why PSERS and SERS Costs will Skyrocket

- Started with Act 9 of 2001
  - 10-year surplus drawdown will cease in 2012. This was done in connection with benefit improvements of 25% for PSERS participants and 25% to 50% for SERS participants.

- Significant investment losses, other benefit improvements and legislation in 2003 which effectively deferred contributions

- This is the convergence of politics and unmanaged risk.

Combined Estimated PSERS and SERS Employer Costs

	PSERS	SERS	TOTAL
FY 2009-10	$617M	$226M	$843M
FY 2012-13	$4.2B	$1.9B	$6.1B
FY 2015-16	$5.5B	$2.3B	$7.8B

NOTES: PSERS costs are allocated ~54% at the state level and ~46% at the local level (school property taxes). PSERS projects a funded ratio of 89% in FY 2020.

Increasing & Compounding Liabilities

Trend: Defer liabilities rather than reforming plan design and funding policies

- PSERS – state & local impact
- SERS – state impact
- State Retiree Medical – state impact
- Local & City Pension – local impact
- Local & City Retiree Healthcare – local impact
- School Retiree Healthcare – local impact

True Pension Reform Must Satisfy Three Basic Principles

1. Funding must be <u>current</u>.
   - Benefits should be funded as they are earned and "paid-up" in the aggregate at retirement
   - Achieving a 100% funded ratio
   - Significant private sector pension reforms occurred in 2006.

2. Costs must be <u>predictable</u>.

3. Costs must be <u>affordable</u>.
   - 5-7% of payroll (net of employee contributions)

The Five Step Pension Reform Program

1. Establish a unified DC plan for new members
   - Curtails open-ended liabilities
   - Eliminates long-term commitments on behalf of taxpayers
   - SB 566 (2009)

2. Prohibit pension obligation bonds or other post-employment benefit (OPEB) bonds

The Five Step Pension Reform Program

3. Mandate minimum funding reforms for any newly created liabilities resulting in both pension and OPEB plans

- For actives – maximum funding period is the average remaining working career of recipients.
- For retirees – 1-year funding period (no remaining working career).
- Permit asset averaging of up to 3 years subject to a 90% to 110% corridor test against the market value of assets.
- No benefit improvements permitted if the result of such improvements causes the funded ratio to fall below 90%.

The Five Step Pension Reform Program

4. Consider modifying unearned pension benefits (if legal and feasible)

   - Reduced formula
   - Redefinition of eligible earnings
   - Increasing the normal retirement age
   - Curtailing early retirement subsidies
   - Eliminating COLAs and Deferred Retirement Option Programs (DROPs)

5. Consider funding reforms only after prior steps are achieved

To omit steps 1,2,3,4 ≠ pension reform.

Municipal Pension Reform

- Enroll new employees in a unified Defined-Contribution plan (SB 566)

- Standardized reporting requirements
  - Annual valuation required for plans with over 250 lives
  - Establish a common plan year of July 1
  - For state reporting proposes – establish a uniform set of actuarial assumptions and methods

- Implement amortization periods which may not exceed the average expected remaining careers of the active workforce

Municipal Pension Reform

- Amortization payments based upon level payment only
- Implement asset values limited to a three-year averaging period and subject to a 90% to 110% corridor of the market value
- Any existing state subsidies will be granted upon successful compliance with these funding reforms
- No state subsidies to employees entering new DC plan

Municipal Pension Reform

- Pension obligation bonds or any other form of third–party debt are not permitted
- No benefit improvements permitted if the result of such improvements causes the funded ratio to fall below 90%
- Effective career management strategies needed for uniformed employees in latter part of careers - prior to age 62

Severely Underfunded Plans (<50%)

- >250 Lives:
  - Replace local pension board with certain conditions:
    - No elected public officials
    - No current or former plan members
    - No one who is a potential supplier to the plan
    - Term limits will apply
- <250 Lives:
  - PMRS assumes plan administration

DBs vs. DCs: Cost Analysis

- Some incorrectly compare a new DC plan with **actual costs** of 5-7% with the **estimated deposits** into a current or new DB plan

- DB estimates ignore ad-hoc pension COLAS, and other unplanned future benefit improvements (Act 9 of 2001)

- Since pension contributions are based upon a uniform rate applicable to all participants, why contribute an estimated 29% into PSERS (or SERS) for new hires where an actual cost of 5-7% could apply in a new DC arrangement?

- Current normal costs (after member contributions):
  - PSERS (7.35%) and SERS (8.42%)

Ten Pension Policy Questions

1. How does deferring pension liabilities make future liabilities more affordable?

2. Why is contributing less into underfunded plans considered reform?

3. What is to prevent additional benefit improvements in poorly-funded plans?

4. If 20-year amortization already defers significant costs to the next generation, why permit 30 years?

5. Why are unaffordable levels of private sector benefit costs considered affordable in the public sector?

Ten Pension Policy Questions

6. Why not design plans based upon the next generation of taxpayers' ability to pay?

7. When will underfunded pension plans achieve a funded ratio of 100%?

8. What is the status of retiree medical reforms and when will these plans achieve a funded ratio of 100%?

9. Given all this, what are the financial incentives to live, work, or invest in Pennsylvania cities?

10. Who will provide the leadership to champion true reform?

Non-Reform Reform Ideas

Reforms we don't need and can't afford…

Item	Detail	Why it is a problem
Pension Obligation Bonds	Floating bonds to fund pension plan deficits	Increases risk to taxpayers with a certain incentive to increase pension benefits
Optional DC plans for new hires - some with annuity payout options		Overall costs exceeding 5-7% will prove unaffordable
An early retirement incentive plan		Enhances already generous benefits. Long amortization periods. Only works if backfill rate is below 40%
"Fresh start" of PSERS and SERS unfunded liability up to 30 years	Creates a new "mortgage"	Promotes generational theft
A new and reduced DB plan		Even a new DB will not escape the politics of public pensions. Consider PSERS and SERS - 10 years ago – lessons of history. Doubles-down on the status quo.
A new hybrid plan	A new DB plan which where the accrued benefit is an account balance	Same design and funding problems associated with defined benefit plans

Defined-Contributions Concerns

- Participation Rates
- Member Contribution Rates
- Investment Diversification Issues
- Installment Payout Options
- Disability Provisions
- Provisions for employees not participating in social security

Ending Where We Began

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