Southern Legislative Conference

Issue Alert

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Actuarial Estimates in Public Pensions

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The Council of State Governments' Southern office, the Southern Legislative Conference (SLC), has researched, reviewed and published a series of reports on the status of public retirement systems in recent years. Continuing this trend, this Issue Alert seeks to apprise policymakers in the SLC states on a recent development in states across the country: the increased scrutiny of actuarial estimates in public pension plans and their role in influencing the overall financial health of these plans.

A number of recent reports and surveys, including several SLC publications and presentations, have documented the unfunded liability levels in public pension plans. One of the most recent reports, published in December 2007 by the Pew Center on the States, demonstrated that retiree pensions and other non-pension benefits (mostly retiree healthcare) amounted to at least $2.73 trillion over the next several decades. This report noted that while states had set aside $2 trillion to pay for promises to their retirees, they still need to find an additional $731 billion to cover their pension and other long-term benefits. States (and local governments) also have been required by a new rule of the Governmental Accounting Standards Board (GASB) to disclose the cost of non-pension benefits, such as healthcare, dental and life insurance in their financial reports. This requirement has resulted in added financial burdens to state and local governments.

Actuaries play a critical role in estimating the financial health of a pension plan by using various methods and assumptions to evaluate the present value of expected cash flows from a pension plan. In the context of the new GASB rules and the furor over the large unfunded liability levels in so many public pension plans, compared to prior periods, actuaries now have become more prominent in the discussions of public policymakers. In addition, there has been recent media coverage over the actions of several state and local governments *vis-à-vis* the role played by their pension actuaries.* There also has been a more fundamental debate over the economic assumptions made by actuaries and whether their methods have kept pace with the enormous changes in the economy. Jeremy Gold, an expert on actuarial, insurance, and pension matters, and one of the first to call attention to this chasm between actuarial figures and economic reality, maintains that actuaries routinely underestimate, by as much as a third, the cost of public pensions.

Based on these developments, the following events involving the role of actuaries in public pension plans remain important:

- Texas: The attorney general is calling for actuaries operating in the state to be registered to ensure tighter oversight and regulation. One of the factors triggering the

* Among the sources reviewed for this Issue Alert was "Actuaries Scrutinized on Pensions," *The New York Times*, May 21, 2008.

attorney general's campaign revolves around the city of Fort Worth's pension fund. The fund faces an overwhelming $410 million shortfall as a result of an actuary, erroneously calculating in 1990, that the city could contribute less money and increase worker benefits concurrently on the assumption that the fund would earn 10.23 percent a year on its investments. Not surprisingly, the pension fund faced onerous financial problems and the city currently is scrambling to reform and resuscitate the fund.

- New York: The Legislature dismissed its actuarial consultant in May 2008 when it learned that he was working for a labor group that was seeking pension enhancements. This actuary had estimated that not only would the cost of the added benefits be zero, but also maintained that the pension fund would be fully funded even during a market downturn. Subsequent analysis also revealed that the actuary had underestimated the ultimate cost to New York City's pension system by at least $500 million.
- Alaska: The state pays for retiree healthcare along with pension benefits, and the state's actuary estimated that healthcare inflation would decline to 4.5 percent by 2009, allowing the state to make lower contributions. On the contrary, healthcare costs have shot up, seriously jeopardizing the fiscal position of the pension plan. Alaska is now suing the actuary for "failing to take into account real-world data."
- New Jersey: In 1994, the state initiated actuarial changes to avoid billions of dollars in contributions to its pension fund. An actuary provided a detailed opinion letter maintaining that the new actuarial method "will securely fund the present benefits" and even produce a modest surplus. When a $4 billion deficit emerged in the pension plan in 1996, the actuary continued to maintain that "the system is funded," notwithstanding the growing shortfall. A decade later or so later, the state's pension plan is tens of billions of dollars in the red, leaving the governor and the Legislature with very grueling choices. In addition, the federal Securities and Exchange Commission (SEC) is investigating the role of the actuary.
- Local Governments: A number of local governments also have been in conflict with the assumptions of actuaries with regard to their pension plans. In Evanston, Illinois, the city's pension plan faces a huge deficit, and its former actuary is accused of using aggressive assumptions about investment returns. In Milwaukee County, Wisconsin, the pension fund faces great pressures and the actuary involved has been accused of underestimating the cost of new benefits introduced in 2001. In San Diego, California, pension estimates provided by an actuary firm were found to be so misleading that the SEC issued sanctions against the city. The city in turn sued the actuarial firm even though the actuarial firm eventually settled.

Given the enormity of the fiscal challenges confronting state and local governments in the current era, it would be extremely prudent for policymakers to carefully review the role played by their pension actuaries in formulating pension fund decisions. Beyond the more obvious flaws, such as conflict of interest issues, policymakers might consider more closely scrutinizing the economic assumptions made by the actuaries to ensure that they are in line with the economic and fiscal realities confronting the specific state or local government. In particular, policymakers should pay particular attention to actuarial projections that rely on overly aggressive investment returns or promise enhanced benefits at little or no cost.

While there are wide variances in the financial health of public pension plans, most detailed analyses demonstrate that states have set aside funds to cover about four-fifths of their long-term pension costs but just a fraction of their retiree healthcare and other non-pension benefits. The renewed focus on the fiscal position of public pension plans has resulted in pushback by certain groups, who stress that a vast majority of public sector pension plans remain sound and on track to meet their future obligations. The critical factor that should be emphasized is that pensions are only one of a range of major expenditure categories that include healthcare, education, transportation, infrastructure and emergency management looming on the fiscal horizon for states. Furthermore, all the elements of our nation's retirement architecture (Social Security, private pensions and personal savings) face tremendous challenges along with the wave of baby boomers that have started retiring. In a souring national economy with state budgets faltering, it is exceedingly important for policymakers to deal with the fiscal challenges in public pension plans expeditiously and comprehensively. Focusing on the actuarial assumptions in their pension plans remain a valuable component of this response and, as Texas attorney general Greg Abbot noted, "[A]ctuarial assumptions based on misinformation is a recipe for disaster."

For additional information on this SLC Issue Alert or details on SLC research on state retirement systems, please visit the SLC website at www.slcatlanta.org or contact Sujit M. CanagaRetna at scanagaretna@csg.org or 404/633-1866.