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PUBLIC PENSIONS
EMERGING TRENDS
A FISCAL ALERT FROM THE SLC

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Public pension systems continue to face significant challenges, a trend that has continued for more than a decade. While public pension difficulties alone would not be a destabilizing force on the economy, the fact that every other element of our nation's retirement architecture also faces complex challenges requires the urgent attention of policymakers at all levels of government. The funding difficulties facing the Social Security and Medicare systems; the rising funding gap at corporate pension plans; record deficits at the Pension Benefit Guaranty Corporation (or PBGC, the federal entity that insures the benefits of private pension plans); low personal savings rate of so many Americans alongside the minimal amounts they have set aside for retirement; the "graying" of America with an increasing number of Americans now reaching retirement age and living longer; and the aforementioned public pension challenges cumulatively amount to a tsunami of red ink.

Two recent reports offer some guidance on the trajectory of public pension plans. In March 2012, Wilshire Associates, the investment consulting and services firm, released its 2012 Report on State Retirement Systems and in June 2012, the Pew Center on the States released The Widening Gap Update. The Wilshire Report indicates that the ratio of assets-to-liabilities, or funding ratio, for all 126 state pension plans was 77 percent in 2011, up from an estimated 69 percent in 2010. The report concluded that the improvement of the funding ratio was driven by the strong global stock market performance in the 12 months ending June 30, 2011. The conclusions in the Pew report were gloomier and noted the $1.38 trillion gap between states' assets and their obligations for public sector retirement benefits in fiscal year 2010, which included $757 billion in pension promises and $627 billion in retiree healthcare obligations. According to the Pew report, only Wisconsin had fully funded its pension plan (100 percent) and 34 states were below the 80 percent threshold, the level experts urge as representing a financially sound pension system. Among the states with well-funded plans were North Carolina, South Dakota, Washington and, of course, Wisconsin, all funded at 95 percent or higher. At the other end of the spectrum was Connecticut, Illinois, Kentucky, and Rhode Island, all funded below 55 percent.

One of the major drawbacks in evaluating public pension is the timeliness of the data, a limitation apparent in the Pew report, which references the fiscal year that ended on June 30, 2010. This report includes a particularly dark fiscal period for states when the rigors of the Great Recession were particularly intense. In fact, the report included the addendum that, since the end of fiscal year 2010, states have initiated an unprecedented number of pension reforms and that these reforms, along with strong investment gains and continued fiscal discipline, will enhance the financial security of these public pension plans. Given the significant improvement in the equity markets, this recovery is already evident in the portfolios of a number of public pension plans.

In calendar years 2009 through 2011, 43 states initiated reforms to stabilize their pension systems including:

- Issuing pension obligation bonds;
- Increasing employee contributions;
- Revising automatic cost-of-living adjustment (COLA) increases;
- Increasing age and vesting levels;
- Lengthening the period that determ ines final average salary for pension benefits;
- Prohibiting any retirement benefit enhancements until the actuarial value of the system's assets reach 100 percent of actuarial funding liability;
- Switching most active members to a hybrid plan with a lower defined benefit (DB) combined with a mandatory participation in a defined contribution (DC) plan;
- Establishing a DC plan as an option for new members; and
- Consolidating pension boards to effect greater oversight and economies of scale.

Beyond these measures, two other trends have surfaced in public pension circles in recent years that require attention: 1) government-run retirement plans for private sector employees and 2) cash benefit plans, which include features of both a traditional DB pension and a 401(k)-style system.

Government-Run Retirement Plans For Private Sector Employees

Having state pension funds run retirement plans for private sector employees is an idea that catalyzed in Maryland five years ago. Since that time, policymakers in over a dozen states (including California, Connecticut, Illinois, Maryland, Massachusetts, Michigan, Pennsylvania, Rhode Island, Vermont, Virginia, Washington, West Virginia and Wisconsin) have discussed and even proposed legislation adopting a similar approach. At the local level, the comptroller of the city

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of New York, the nation's largest local government, also has expressed interest in the idea.

At the outset, it is important to stress that none of the proposals being discussed or proposed require any public funds to be allocated to pay for private sector retirement plans. The funds managed for private companies would be kept strictly separate from the monies managed for public sector employees. Specifically, the proposals revolve around permitting the state retirement system to administer retirement plans for these private sector individuals by collecting their pension contributions and overseeing the portfolio managers administering these accounts. Supporters of the measure indicate that economies of scale would ensure that administrative costs would be kept to a minimum. In fact, in a large state like California, the opportunity to bring in a significant number of private workers of varying ages enhances the likelihood of the plan 'riding out' market downturns and faring well in the long term.

The impetus to offer an option for private sector employees to participate in a state-administered retirement plan springs from two important trends related to private sector pensions: 1) the pension plans in an increasing number of private companies are in serious financial difficulty and 2) an increasing number of Americans have failed to save adequately for retirement.

At the end of 2011, pension plan assets at S&P 500 companies covered only 74 percent of estimated liabilities, a deficit of roughly $450 billion. In addition, in fiscal year 2011, the PBGC's deficit increased to $26 billion, an increase from the $23 billion in the prior year. In its role as the insurer of private pension plans, the PBGC already is responsible for the retirement benefits of about 1.5 million Americans. Its obligations for these and other purposes totaled $107 billion in fiscal year 2011. A corollary to this trend is that an increasing number of private companies simply are discontinuing their pension plans or not offering retirement benefits at all.

The Washington, D.C.-based Employee Benefit Research Institute, an organization that seeks the development of employee benefit programs and sound public policy through research and education, notes in its 2012 Retirement Confidence Survey that a mere 14 percent of American workers are confident that they have sufficient funds to live comfortably in retirement. More disturbingly, the survey reported that many workers have virtually no savings and investments, and a dismal 60 percent of workers reported the total value of their household's savings and investments, excluding the value of their primary home and any defined benefit plan, as less than $25,000. Also of interest is the survey's finding that 81 percent of eligible workers (or 38 percent of all workers) contribute to an employer sponsored retirement savings plan, such as a 401(k). John Liu, New York City Comptroller, became interested in government-run retirement plans for private sector employees after realizing that the metropolis was in "the early stages of a burgeoning retirement crisis," given that "more than a third of all retirement-age households had nothing to rely on except Social Security."

Given these twin trends, legislators in the aforementioned states have pursued enhancing the retirement security of private sector workers without company established retirement plans, not only for the individuals benefit, but also to mitigate the likelihood that these individuals will seek public assistance during retirement. In Wisconsin, state Senator Dave Hansen has proposed a separate but equal system for non-government workers such as small business owners and farmers. Similarly, in California, state Senator Kevin DeLeon sponsored legislation that would create a state-run, privately insured plan for private workers in companies that do not offer retirement benefits, and calls for private employees contributing 3 percent of their wages to deliver the sort of safe returns found in long-term U.S. Treasury bonds. He maintains that there is a crucial difference between his proposal and the DB pensions provided to state employees by the state's giant public sector retirement plans (CalPERS and CalSTRS): "the private employee pensions are designed as modest supplements to retiree Social Security benefits. The point is simply to improve the safety net that Social Security provides, keeping more people from relying on state aid." In contrast, the CalPERS and CalSTRS pensions are designed to sustain career state employees after retirement.

Cash Balance Plans

Another trend that has surfaced in several states in recent years, most notably in Louisiana, Kansas, Maryland, Montana and Pennsylvania, is cash balance plans, which contain features of both a traditional DB system and a 401(k)-style system. One of the first states to move to a cash balance system was Nebraska. In 2003, the state shifted all new hires to the cash balance plan, a fairly uncommon approach among public retirement systems at the time. While both employees and the state contribute to individual accounts, the plan is administered by the state's retirement agency, the Nebraska Public Employees Retirement Systems. The state contributes $1.56 for every dollar the employee contributes and the state guarantees that each account will earn at least 5 percent a year. During a period when investment earnings are strong and the plan meets minimum funding requirements, the retirement system pays out an annual dividend to employees in the plan. Importantly, the state does not pay for automatic COLA increases, though employees may finance this out of their retirement accounts. The fact that the state retirement system manages the investments for employees is an appealing feature to employees that have neither the expertise nor the discipline to competently manage their accounts. Upon retirement, employees have the option of claiming their individual retirement accounts as an annuity, lump sum, rollover or a combination of these approaches.

While states have the potential to save significant amounts of money by moving to the cash balance system adopted in Nebraska (as much as $1 billion annually, according to a study in Maryland), there is speculation on whether it provides an adequate source of retirement income. If the goal is to provide supplementary income to other sources of retirement income, it might be appropriate. However, the Maryland study noted that a state worker earning $40,000 a year and saving the maximum allowed amount would exhaust their entire account 13 years after retiring. From the state perspective, the opportunity for employees to inflate their final three years of salary through "spiking" (sick leave, overtime, promotions, last-minute raises) is eliminated since retirement payments are not based on a formula, a development that generates savings for the state.

In conclusion, states continue to face significant challenges in grappling with public pensions but, importantly, policymakers continue to devise solutions to mitigate the adverse consequences of these difficulties. Since unfunded pension liabilities are long-term liabilities that do not require resolution in a year or two, continued state action to enhance the retirement architecture of all Americans remains critical.