



A Comprehensive Proposal for Reforming Pennsylvania's Unsustainable Retirement Systems

Richard C. Dreyfuss
Business Consultant and Actuary
Senior Fellow - The Commonwealth Foundation
Adjunct Fellow - The Manhattan Institute

PA Senate Finance Committee
April 15, 2015

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.”

Three Factors Drive the Political Institution of Public Pensions

- 1) Poor Benchmarking
- 2) Poor Liability Management
- 3) Politics

Recent National Headlines

- ***Experts tell CalSTRS earnings may fall short of 7.5% assumed rate***
 - The CalSTRS board was told this month that financial experts are forecasting investment earnings of 7 percent a year or less during the next decade, below the 7.5 percent assumed by the pension fund. *Calpensions.com*. Posted Oct. 27, 2014
- ***R.I. pension fund advisers suggest state consider further reduction of annual returns*** – Providence Journal – September 12, 2013
 - The Cheiron (actuarial) team ... says the board should “consider lowering” its assumed 7.5 percent rate of return because there is only a 40-percent chance the yields will be that good over a 20-year period.
- In his “You Only Dance Twice” outlook, Bill Gross said investors should lower expectations for stocks to 5% and 6% and for bonds to 3% to 4%.
- ***Rising U.S. Lifespans Spell Likely Pain for Pension Funds***
Wall Street Journal - Oct 27, 2014
 - Society of Actuaries Boosts U.S. Life Expectancies by About Two Years

From the Credit Rating Agencies

July 16, 2013: Fitch cuts Pennsylvania credit rating, cites pensions

- “The funding levels of the Commonwealth’s pension systems, which have been historically adequate, have materially weakened, with ***annual contribution levels remaining well below actuarially required levels.***”
- Together, Pennsylvania's problems “***signal an inability or unwillingness on the part of political leaders to make difficult fiscal decisions,***”

Moody’s (March 29, 2013) and Standard & Poor’s (April 2, 2013) opinions expressed similar conclusions and outlooks.

#3 Politics

Pensions as political capital

- **Pension Fund Surplus** = Represents Political Capital & Potential Benefit Improvements for Active and Retired Plan Participants
- **Pension Fund Deficits** = Underfunding by Taxpayers
- **Maintaining or Improving Benefits** = High Political Rate of Return
- **Reforming and Properly Funding Plans** = Low Political Rate of Return

Politics and Defined Benefit Plans A Toxic Combination

Politics means forces within the pension system responsible for the following actions, which can also be done repeatedly:

- 1) The tendency to promise and perpetuate retirement benefits that are generally benchmarked only against other public-sector pension systems.**
- 2) The use of rosy economic assumptions to minimize current and future costs**
- 3) Retroactively improving benefits or granting ad-hoc benefit improvements**

Politics and Defined Benefit Plans A Toxic Combination

- 4) The (re)deferral of both liabilities & proper contributions to avoid either raising taxes or reducing budgets**
- 5) Postponing the attainment of a 100 percent funded ratio to a time well beyond the average remaining career duration of the current workforce**

True Pension Reform Must Satisfy Three Basic Principles – **Using Realistic Funding Assumptions**

1. Funding must be current.

- Benefits should be funded as they are earned and “paid-up” in the aggregate at retirement. Achieving a 100% funded ratio.
- PSERS average age is 44.5. Avg. retirement age 60.9

2. Costs must be predictable.

3. Costs must be affordable.

- 4-7% of payroll (net of employee contributions)

Five Step Public Pension Reform Plan

- 1. For all new hires, establish a standardized DC plan with an annual employer cost of 4% to 7% of pay. No excluded employee groups. (Higher match of 9% to 10% for non-members of Social Security)**
 - Eliminates excessive plan risks to current and future taxpayers
 - Removes politics from pensions
 - No unfunded liabilities, portable benefits, individual accounts
 - Total employee and employer contributions should target 12% to 15% of pay. Default investment option is “target (retirement) date” funds.
- 2. Statewide prohibition of pension obligation bonds. This concept also precludes other borrowing strategies to finance benefit plans.**
- 3. Enact funding reforms consistent with The 2014 Blue Ribbon Panel’s Report on Public Pension Plan Funding .**
 - Amortization periods for unfunded liabilities should not exceed 20 years. Asset averaging should not exceed five years.
 - Actuarial assumptions should be at least 50% achievable (long-term).
 - There are no plan design “savings” scenarios which justify continuing any rate “collaring”.

Five Step Public Pension Reform Plan

4. **Modifying unearned pension benefits** (as legally permitted)
 - This includes redefining early and normal retirement benefits and increasing member contributions.
 - Suspending benefit accruals when funded ratios fall below 65%
 - Revising Other Post-employment Benefits (OPEB) (this includes retiree healthcare)

5. **Consider funding reforms only after prior steps are achieved**
 - Challenge is to do this without increasing taxes or through new borrowing

Omitting any steps ≠ comprehensive pension reform

Pseudo-Reforms – Avoid These Actions

Item	Why it is a problem
1) Using pension obligation bonds or other borrowing strategies to finance pension systems	Further leverages pension system and creates an incentive to improve benefits
2) Adopting early retirement incentive plans	Enhances already generous benefits; a false economy
3) “Fresh start” (reset) of any unfunded liability especially beyond the average remaining duration of the workers’ career (usually 15 to 20 years). ➤ Other funding techniques that defer costs, including assigning these costs to new employees	A political dodge that burdens future generations.
4) A new and reduced DB plan and/or an optional DC plan	Neither will escape the politics of public pensions
5) A “hybrid” DB plan: a cash balance DB or a reduced set of DB and DC plans	Same politics and funding issues associated with all defined benefit plans

Correcting Common PA Pension Half-Truths

#	Half-Truth	Important Fact
1	Transition costs (TC) in closing a DB plan should preclude consideration of a DC plan.	TC are significantly overstated and should not preclude closing a DB plan. Consider private sector experience
2	Michigan and Alaska experienced a significant increase in the unfunded liability (UL) after closing their DB plans.	Increases in the UL were related to underfunding and poor investment returns.
3	DB plans are 48% cheaper than DC plans to provide equivalent benefits.	Based upon very debatable assumptions. Conflates group pooling with individual accounts.
4	Act 120 (2010) just needs time to work.	The 2010 projected expected savings <u>will not materialize</u> due to lowered asset return assumptions & reduced number of active participants.

Correcting Common PA Pension Half-Truths

#	Half-Truth	Important Fact
5	The unfunded liability reflects the deficit assuming everyone retired today.	Generally, this deficit is the value, in today's dollars, assuming members retire on their expected dates.
6	The DB annual normal cost (NC) represents the true measure of long-term pension costs. The NC can be readily compared to the annual DC employer match. (Using what set of actuarial assumptions?)	If true, then why do we have any unfunded liabilities? NC is simply an estimated annual deposit based upon the actuarial assumptions and other variables. (It does not reflect any unplanned events including underfunding.)
7	Retirement income security cannot be achieved through a DC plan	Best practices in DC plans can mitigate risks to help achieve retirement goals.
8	The PSERS & SERS uncollared contribution rates represent the appropriate pension funding standards.	Need to adopt pension funding reforms which include shortening amortization funding periods.