BLUE RIBBON PANEL ON PUBLIC PENSION PLAN FUNDING

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INTRODUCTION

As I reported at the Board of Supervisors meeting on February 25, recommendations had been released a day earlier, on February 24, by a blue-ribbon panel of the Society of Actuaries (SOA) — the entity responsible for education, testing and licensing in the profession — to improve the financial health of public pension plans. The blue-ribbon panel was formed in by the Society of Actuaries in 2013. It was intended to be multidisciplinary panel of experts that could provides new guidelines for trustees, legislators and plan advisers. The blue-ribbon panel said the new guidelines were necessary, because the total amount of unfunded public pension plan liabilities in the U.S. amounts to more than $1 trillion, according to some estimates.

The blue-ribbon panel in its report went on to say that both public pension plans and their plan sponsors, needed more precise, meaningful information about the health of public pension funds so that trustees, legislators and plan advisers, as well as citizens, could have the facts they needed to work together to make informed decisions about the future of their plans.

This blue-ribbon panel of the Society of Actuaries laid out a path to strengthen public defined benefit plans, while championing the valuation of pension liabilities in a more economically realistic way.

Depending on the path sponsors take, these areas can contribute to strengthening or weakening public funds. Public retirement systems have tended to favor expedient approaches that lowered pension contributions and liabilities in the shorter term, but in the longer term undermined long-term funding levels and retirement security.The proposal, presented in the report that was released on February 24, frames the issue of improving funding levels by tackling the conflicting objectives of pension plans, including cost stability vs. investment volatility and intergenerational equity vs. short-term public budgeting pressures.

The question is whether the constituencies involved with public funds, including actuaries, pension trustees, and the Actuarial Standards Board, will accept the SOA panel's recommendations.

There is no doubt that the recommendations in the report should be embraced. But the impulse in the past has been to resist infusing the systems with better economics. When the Governmental Accounting Standards Board (GASB) sought to change the accounting method for valuing liabilities, it was pressured to moderate its initial ideas. These watered-down proposals resulted in GASB Pronouncements 67 and 68, which will be implemented in 2014 and 2015, respectively. GASB 67 and 68 are a good start, but it's only a start. It's not the final word on pension reform.

With the SOA panel's new proposals, it is in the interest of proponents of public retirement systems, including actuaries, to change. We must all support pension reform. Otherwise the systems sow their own seeds of destruction as the political pressure builds to scrap defined benefit plans and move to defined contribution plans, thereby putting all investment risk onto participants.

The SOA panel's proposal sought only to help public sponsors to make their systems stronger.

RECOMMENDATIONS

One of its key recommendations is that public retirement systems should use a forward-looking rate to discount pension liabilities to give a truer economic picture of plan costs, rather than historical plan returns, which tend to understate liabilities.

The new rate would replace the actual long-term rate of return on plan assets generally used now by sponsors and their actuaries to discount liabilities and set contribution levels.

The SOA's blue-ribbon panel could have, and perhaps should have, have gone further and recommended the use of a risk-free rate — or the rates on the Treasury yield curve — for valuing pension liabilities. In the 68-page "Report of the Blue Ribbon Panel on Public Pension Plan Funding," the 12-member, blue-ribbon panel recognized the superiority of the use of the risk-free rate for such valuation.

"Economic theory suggests that achieving full intergenerational equity means that current taxpayers should pay the "risk-free' cost of services so as not to burden future taxpayers with the cost of investment risk being taken by current taxpayers," the report said.

"The panel recognizes that most plans prefer the lower current cost achieved by assuming higher expected investment returns (and therefore higher risk taking and a possible shift of costs to future generations), as opposed to preserving pure intergenerational equity."

Benefits that are riskless, such as those pension benefits protected by provisions in state constitutions that prohibit reductions, should be discounted at the risk-free, or at least a very low, rate to provide for funding adequacy to ensure pension promises are kept.

Public plans believe their sponsoring entities, states and cities, don't go out of business, enabling them to withstand short-term market and funding challenges and use a higher assumed rate. But the bankruptcy filings by Detroit and some other cities reveal the fallacy of that thinking. States cannot seek bankruptcy, but economic challenges might force their taxpayers to do so, or at least be unable to bear further economic burdens, making difficult raising revenue to finance pension contributions.

The SOA's blue-ribbon panel instead chose a forward-looking rate, which it said would be lower than the rate generally in use now by public sponsors. For forecasting the rate, "it is important to consider the extent to which future economic and market conditions may differ from those of today or of the past," the report said, noting "the long-term secular decline in interest rates … strongly suggests that the robust fixed-income performance of the past is not likely to be repeated in the future."

The panel incorporates the risk-free rate as a risk management tool as part of its recommendations to enhance disclosure of public systems. It recommends using the risk-free rate for reporting purposes to discount liabilities and to compare it against the investment return assumption as a way to gauge the level of investment risk taken by the plan. Such a move would be a good step toward assessing the risks and costs of plans.

The underfunding of plans tends to derive from a lack of contributions and the overpromising of benefits, including cost-of-living increases, rather than from insufficient returns on assets. Many funds have tended to achieve their assumed rate of return over the long term.

“Funding adequacy and intergenerational equity should take precedence over the goal of cost stability and predictability,” the report said. Even though “predictability of cost in the short term is important for public budgeting purposes,” the report said, “allocating a significant portion of investments to higher-risk, more volatile assets will tend to undermine the goal of cost stability.”

In addition, the panel recommends governmental entities responsible for funding and plan trustees “should strive to fund 100%” of pension obligations, rather than the 80% typically considered as adequate. “Financial resources, including both current and future contributions, should be adequate to fund benefits over a broad range of expected future economic outcomes” and “respond to changing economic conditions,” the report said.

Among the recommendations, the report calls for other enhanced disclosure, which would help taxpayers understand the complexities of pension finance and could build support for strengthening plans.

The panel plans to take its recommendations to the Actuarial Standard Board (ASB), which adopts standards of practices for the actuarial industry. The process might take some time to play out, even if the ASB embraces the panel’s recommendations.

Trustees should not wait; they should adopt the suggestions. That would take agreement from the funding sources of public plans, especially state and local legislators. But the status quo leaves the plans vulnerable to underfunding.

If public entities, like Mendocino County, want to keep defined benefit systems, they have to make funding a priority. The SOA’s blue-ribbon panel shows them how to do it. If we fail to act, we need not look any further than Detroit to see the future of our county’s pension system.

A CASE STUDY: DETROIT

Detroit is the teachable moment. For all their hundreds of billions of dollars, public pension systems are largely unregulated. Actuarial standards, however obscure, may be the closest thing the sector has to a uniform and enforceable code. And the code has just been updated, thanks to Detroit.

Again, to review, the SOA’s blue-ribbon panel recommend that pension actuaries provide plan boards of trustees and, ultimately, the public with the fair value of pension obligations and estimates of the annual cash outlays needed to cover them. That means pension officials would disclose something they have long resisted discussing: the total cost, in today’s dollars, of the workers’ pensions, assuming no credit for expected investment gains over the years.

“We think it would be a useful benchmark for plans to have,” said Robert W.Stein, the panel’s chairman, who is both an actuary and a certified public accountant. “We’re optimistic that the information would enable them to better appreciate the future and what it might bring.”

Economists refer to this elusive number as the plan’s total liability, discounted at a risk-free rate. The SOA has called for its disclosure for years, saying it would help pension trustees make better decisions. Economists have calculated rough approximations in recent years for various states and cities, but only the plan actuaries have the data needed for precise calculations.

Though the actuaries who work for public pensions have the capacity to spot risks and measure shortfalls with pinpoint accuracy, it is their clients — usually the pension trustees — who call the shots. And plan trustees prefer to be given traditional actuarial estimates, which are smoothed, stretched, averaged, backloaded and otherwise spread across time.

Such numbers generally comply with current actuarial standards, but as Detroit shows, they can also paper over looming disasters. Detroit's pension fund was said to be healthy just before the bankruptcy, but it turned out to be several billion dollars short.

The new liability measurement called for by the Society of Actuaries panel would not be the only number provided to the public, but it would provide new insight into the market risks for pension plans and the shortfall that might have to be made up by local taxpayers if investment returns did not measure up to expectations.

Disclosing pension liabilities based on risk-free discount rates, however, is viewed with deep suspicion by plan trustees and the unions that represent public workers. Pension officials and union leaders say the risk-free approach, if permitted, will be used to cast public pensions in the worst possible light to whip up fervor against them and justify the termination of the plans.

A CASE STUDY: NEW YORK CITY

So far, the only public pension actuary who has publicly provided such numbers is Robert C. North Jr., who tracks the five funds that make up New York City's vast pension system. He is also one of the 12 members of the blue-ribbon panel. (Other members include New York's former lieutenant governor, Richard Ravitch; the Pension Benefit Guaranty Corporation's former executive director, Bradley D. Belt; and the Principal Financial Group's chief executive, Larry D. Zimpleman.)

For New York City's biggest fund, known as the New York City Employee Retirement System (NYCERS), the conventional numbers show assets of about $45 billion and liabilities of $67 billion, or a less-than-stellar funded ratio of 66 percent.

But Mr. North's fair-value numbers, deep in NYCERS's annual report, show assets of $43 billion and liabilities of $106 billion, or a funded ratio of just 40 percent — a sure sign of trouble ahead as the city's work force ages and retires.

The difference, $63 billion, is NYCERS's shortfall. That money has to be made up before today's city workers retire — within 14 years, on average. As a result, New York's contributions to Nycers are rising every year, squeezing the city budget and making it harder for the city to provide public services.

Mr. North said in 2006 that he tried to give these numbers greater prominence in the annual reports, but was blocked by the plan's outside auditor, who said that doing so did not comply with generally accepted accounting principles.

Detroit felt an even bigger budget squeeze over the last decade. But, unable to see the hopelessness of its situation, the city borrowed $1.4 billion from the bond markets, put that cash into its pension system and declared victory. The money was invested in assets that subsequently lost value, the workers kept on accruing new benefits, tax revenues continued to falter and finally, last year, that debt was the first thing Detroit defaulted on as it hurtled toward bankruptcy.

New York City now says the borrowing transaction was an illegal sham and has asked the bankruptcy court to void it. Bondholders have been told to expect pennies on the dollar for their claims. Pensioners' losses in the bankruptcy will be softened, but some of them have been warned that their pension checks will be docked to offsetimproper payouts in the past.

Detroit might have gone bankrupt in any case, but the pain might have been lessened if better decisions had been made early on to address the rising cost of the benefits in the face of the shrinking tax base.

For other places that may have the same problem, the blue-ribbon panel is calling for actuaries to produce other details as well: each pension plan's projected annual cash payments; the estimated volatility of the fund's investment performance; and something called a "standardized plan contribution," which would help all stakeholders assess whether the actual contributions to a pension fund, paid by workers and taxpayers, are reasonable and adequate.

"One would think that alert trustees would want to review this," Mr. Stein said, "and evaluate how they should respond."

Mr. Stein said the panel had asked the Actuarial Standards Board to incorporate its recommendations into its professional standards, or perhaps into a new standard solely for public pensions.

PENSION OBLIGATION BONDS AREN'T THE ANSWER

The blue-ribbon panel went on to say in its report that public pension plans should not be funded with instruments that bear risk or delay cash funding, such as pension obligation bonds.

"Plans are not funded in a broad budgetary sense when debt is issued by the plan sponsor to fund the plan, whether inside or outside the plan," said the panel.

The panel said that effective pension funding programs should follow three principles. One of the principles is adequacy, or the goal to fund 100% of the value of promises made; the second principle is intergenerational equity, or the goal that current employee costs will not be borne by future taxpayers; and the third principle is cost stability and predictability.

To state it another way, pension obligation bonds aren't the answer to funding a chronically underfunded plan.

The panel recommended several good governance characteristics that pension systems should adopt. One of these is that plans should maximize the likelihood that funding objectives be achieved. Plans should also ensure that recommended contributions are paid, and that complete financial information is disclosed to all stakeholders. Finally, the use of financial instruments that delay cash contributions, like pension obligation bonds, should not be encouraged, the report said.

CONCLUSION

The report recommended that the Actuarial Standards Board require several types of financial and risk measures to be disclosed in actuarial reports.

Trends in financial and demographic measures should be disclosed so that a plan's stakeholders can understand its changing profile and risk position. Plans should present information for a 10-year period about various plan maturity and cost measures. Additionally, the report said, plans should present information that allows users to compare economic and demographic assumptions with actual experiences.

Actuaries also should disclose three benchmarks in order for current risk levels to be understood, the report said. Those benchmarks are: the expected standard deviation of investment returns of the asset portfolio on the report date; the plan liability and normal cost calculated at the risk-free rate; and a standardized plan contribution that can be compared to the recommended contribution to help users asses the recommended contribution's adequacy.

Additionally, plans should be stress tested to see both the effect of paying only 80% of the recommended contributions each year for 20 years, and the effect of investment returns over a 20-year period that are three percentage points greater and less than those used in calculating the standardized plan contribution.

Also actuaries should provide two sets of benefit payment projections for current employees, one on an earned-to-date basis and the other on a projected-benefit basis, the panel said.

In addition to urging the Actuary Standards Board (ASB) to require the disclosures, the panel calls for the board to require actuaries to include in their reports "an opinion on the reasonableness of fund methods and assumptions."

The report also makes specific recommendations about methods and assumptions that plans use for funding calculations. The panel believes that the rate of return assumption should be forward looking and based primarily on the current risk-free rate. Also, gains and losses should be amortized over a period of no more than 15 to 20 years. It says asset smoothing periods should be no more than five years.

Actuaries should consider direct-rate smoothing and other asset and liability cash flow modeling techniques, because these approaches "can provide greater transparency into the current financial position of the trust, the level of risk in funding assumptions, and enhanced flexibility to sponsors in the development of sustainable funding programs," the report said.

The panel recommends several good governance characteristics that pension systems should adopt. One of these is that plans should maximize the likelihood that funding objectives be achieved. Plans should ensure that recommended contributions are paid, that complete financial information is disclosed to all stakeholders and that financial instruments that delay cash contributions are not used, the report also said.

Pension systems should also ensure that trustees are properly trained and have sufficient information to be able to analyze risk. They also should carefully consider plan changes. For example, Mendocino County's Retirement Board could require that consideration and adoption of plan changes be done over two or three legislative sessions of the Board of Supervisors. The Retirement Board should also adopt a formal process for evaluating the implications of changes. Meanwhile, the Retirement Board should avoid certain high-risk plan features. There is no free lunch when an underfunded plan tries catch-up. It's a fool's bet that high-risk investments will lead to a fully funded plan.

In conclusion, it is my personal recommendation that the Board of Supervisors and the Retirement Board schedule a joint meeting and workshop in the near future, and at that meeting, Mendocino County's actuaries, Mr. Paul Angelo, Senior Vice President and Actuary and/or Mr. Andy Young, Vice President and Associate Actuary, both of the Seagal Company, should be invited to present their views on the findings and recommendations Society of Actuaries Blue-Ribbon Panel on Public Pension Funding.

Respectfully submitted to the Mendocino County Board of Supervisors on March 25, 2014,

John Sakowicz