

*What are we going to do with these *&%)# Defined Benefit Plans?*

A DIFFERENT PERSPECTIVE

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Public plan sponsors are in a tough spot

Decreased Revenues

- ◆ Economic slowdown reduces fees and taxes
- ◆ Residential real estate bubble burst – reduced taxes

Stock Market Woes

- ◆ The 'lost' decade
- ◆ Actuarial return assumptions not achieved for smoothed period

Public perception and political pressure

- ◆ DB economics is difficult, misunderstood, misquoted
- ◆ Pension envy
- ◆ Pandering



Looking for the Silver Bullet – what are the options?

Everyone wants to reduce costs - NOW

- ◆ Stay the course / be patient
- ◆ Terminate plan - existing plan liquidated; accrued benefits paid out to plan members; City responsible for any deficit; all current and future employees join new plan
- ◆ Freeze plan - accrued benefits of current employees in existing plan “frozen” and paid out at retirement; all current and future employees join new plan
- ◆ Close plan - existing plan closed to new members; current members stay in existing plan until they retire or leave the city; future employees join new plan
- ◆ Restate plan – all current and future members receive reduced benefits from restatement date forward



Unfortunate Realities

- ◆ None of the options reduce costs in the near term
- ◆ The timeframe of the solution far exceeds the term of the elected officials.
- ◆ Sponsors do not want to admit that often they were part of the problem.
- ◆ Lack of understanding of the return assumption
- ◆ Today's society does not value commitment
- ◆ Today's sense of entitlement



Beyond the hype – where are the savings?

Terminating the plan

- ◆ Savings achieved only IF the plan is significantly overfunded today.

Freezing / Restarting / Closing the plan

- ◆ Current plan must be maintained
- ◆ Assumptions must be adjusted to reflect changes, such as negative cash flows
- ◆ Added costs incurred in creating and operating new plan
- ◆ Savings achieved MANY years down the line – perhaps decades before a break-even to current costs.



Unintended consequences – creating HR problems

Most often two-tiered benefit plans cause friction

- ◆ Jack and Jill start within 3 months of each other, but Jack is in closed DB and Jill is in new DC.
- ◆ 20 years later, Jill is Jack's supervisor, but while Jack is 5 years away from a 50% retirement, she only has \$175,000 in her DC account.

Competitiveness and Training Costs

- ◆ Seasoned employees begin to recognize the importance of secure retirement benefits – turnover will increase.
- ◆ Turnover will significantly increase training costs, while reducing the costs of nearby communities.
- ◆ Citizens suffer from reduction of quality of services, and in fact fire insurance costs can increase due to lower ISO ratings.



The Goose and the Golden Eggs

- ◆ Plan sponsors are legally required to fund the plan to actuarial soundness.
- ◆ Participants always want increased benefits
- ◆ Tendency toward keeping up with the Joneses.
- ◆ Both sides need to understand that revenues do not grow on trees.
- ◆ Preservation of the plan needs to be a shared goal with realistic expectations.
- ◆ Conduct an experience study.
- ◆ Review results to generate ideas.



Claims That Bond Debt, Pension Costs Will Cause Imminent State and Local Budget Meltdown Are Exaggerated¹

- ◆ A spate of recent articles regarding the fiscal situation of states and localities have created the misguided impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown, according to a major new report from the Center on Budget and Policy Priorities. These articles mistakenly lump together states' and localities' current, largely recession-related fiscal problems with longer-term issues relating to bond indebtedness, pension obligations, and retiree health costs.
- ◆ Claims that states and localities have \$3 trillion in unfunded pension liabilities that may drive them into bankruptcy are similarly exaggerated, according to the report. The oft-cited \$3 trillion figure is based on valuing future liabilities on a so-called "riskless rate," which looks at future costs assuming a rate of return based on conservative investments such as Treasury bonds. This is distinct from the amount that pension funds actually would have to contribute to their funds to cover their liabilities. State pension trust funds are invested a diverse mix of stocks, bonds, and other instruments and have earned a much higher return in recent decades than riskless investments. If one follows accepted state and local accounting rules and calculates pension liabilities using the historical return on plans' assets, the unfunded liability stands at a more manageable \$700 billion.

¹Headline of recent article discussing report from the Center on Budget and Policy Priorities, January 2011



Markets are cyclical, and we have just been through the big dip!

- ◆ Being patient is an action
- ◆ Remember that markets move in cycles, and the economy is improving.
- ◆ Long-term investment returns of public funds continue to exceed expectations. Since 1985 – a period that has included three economic recessions and four years of negative median public fund investment returns – actual public pension investment returns have exceeded assumptions. For the 25-year period ended 12/31/09, the median public pension investment return was 9.25%. Moreover, for the year ended 6/30/10, this return was 12.8%.⁹ These actual returns exceed the 8% average public pension investment assumption, as well as the average assumed rate of return used by the largest corporate pension plans.¹

¹ NASRA report issued January, 2011



In Summary

- ◆ Defined Benefit plans are a long-term proposition
- ◆ Long-term fundamentals are solid
- ◆ Long-term returns will achieve the necessary result
- ◆ There are no silver bullets to 'fix' the funding shortfall
- ◆ Elected officials need to be reminded that this should not be used as a political tool

