

Retirement Readiness in the Public Sector

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The summer of 2014 was awash with reports highlighting a broad-based lack of retirement preparedness and little confidence of retirement security among American workers.¹ The notion of a secure retirement has long been built upon the concept of the “three-legged stool”—employer sponsored pension plans, Social Security benefits, and personal savings. However, the employer-sponsored leg of the stool is not available to half of private sector workers. Even when available, the trend has changed from an employer-sponsored defined benefit plan to a defined contribution plan in which the employee participation or level of participation is often not mandated. This has resulted in employees shouldering the investment risk and longevity risk of their retirement security.

The retirement preparedness and retirement security of public sector workers is a different story. The employer-sponsored leg of the stool for public sector workers is in place and contributes to retirement security by mandating participation, professionally managing investments, and providing a lifetime annuity at time of retirement. However, public pension plans have also received media attention concerning the sustainability of the plans following the highly-publicized municipal bankruptcy of Detroit and reports of funding ratios of large state systems, such as New Jersey and Illinois, falling below 70 percent. These cases are more the exception than the rule, as many plans maintain a funded ratio of better than 70% (the median funding ratio as of FY2013 was 73%), with some notably at or above 100 percent.²

Background — Public Pension Plans

It is important to recognize that pension benefits are part of an employee compensation package intended to attract and retain skilled, qualified employees in the public workforce -- teachers, engineers, health workers, police and firefighters, to name a few. Public pensions

¹ “Retirement plan participation in 2013 continued on the downward trajectory observed between the 2007 and 2010 surveys for families in the bottom half of the income distribution. Participation rebounded slightly for upper-middle income families, but it did not move back to the levels observed in 2007.” Federal Reserve’s 2013 *Survey of Consumer Finances*

“The National Retirement Risk Index (NRRI) shows that half of today’s working families are “at risk” of not being able to maintain their standard of living once they retire.” Center for Retirement Research at Boston College Issue Brief July 2014, Number 14-11

Eighteen percent of American workers say they are very confident of having enough money for a comfortable retirement, while 37 percent are somewhat confident, and 24 percent are not at all confident. Employee Benefit Research Institute 2014 Retirement Confidence Survey, March 2014 No. 397

² Wisconsin, North Carolina, South Dakota to name a few.

cover 17 million public employees, provide retirement benefits to 8 million annuitants, and manage \$3.7 trillion in assets as of December 2013 (Federal Reserve 2014 2nd quarter report).

The great majority of public pension plans offer a traditional defined benefit program based on a lifetime annuity that is calculated using a formula based on years of service, a multiplier, and a final average salary (usually a three or five year average). Some public plans are a “hybrids” consisting of a smaller base defined benefit plan combined with a defined contribution plan³ or cash balance plan. Regardless of whether a public plan is a traditional defined benefit, hybrid, or defined contribution, all share one common feature: participation in the plan is mandatory.

In a substantial departure from private sector defined benefit plans, the majority of the defined benefit plans in the public sector mandate employee contributions. Likewise, employee contributions to the defined contribution plan are also mandated. The contribution amount to either type of plan is usually established as a percentage of pay and is collected each pay period. The contribution rate may be a fixed amount or subject to change depending on the condition of the plan and other factors.⁴ Mandatory participation and mandated contributions is in contrast to the inertia observed in private sector defined contribution plans.

Pooled investment risk and pooled longevity risk are two additional key elements of the governmental defined benefit plan. Public plans are prefunded. They are no longer financed on a pay-as-you-go basis. The employer and employee contributions are pooled and professionally invested, and typically finance 60-70 percent of the benefits annually. Unlike the individual accounts in a defined contribution plan, the investment return on the trust fund does not determine the retirement account for any one individual on any one particular day. The trust fund is managed to pay benefits to those already retired, those expecting to retire soon as well as those who will not retire for another 20 to 30 years. This allows the trust fund to be managed with a long-term perspective over multiple market cycles.

Finally, most defined benefit plans require participants to receive all or most of their benefit as a lifetime annuity. In this manner, the public plan pools the longevity risk across plan participants. In a pure defined contribution plan or a plan that allows a lump sum distribution, individuals alone bear the risk of ensuring there are sufficient funds throughout their retirement years.

Challenges and Reforms

The primary strains on retirement planning over the past decade have been market downturns and inconsistent, inadequate funding. All retirement accounts (public and private sponsored plans and individual accounts) suffered from the market downturns of the tech bubble of 2000-2001 and the Great Recession of 2008-2009. However, with the pooled investment risk and long-range investment horizon of most public plans, there is time to make adjustments to restore stability.

The first key to restoring stability is funding discipline. Plan sponsors must commit to funding the promised benefits. Contributions to the system must be actuarially determined and paid in full. Many of the plans featured in today’s headlines as poorly-funded suffer from long-term

³ This is different from a deferred compensation plan that is made available as a voluntary savings plan supplemental to the employer’s plan.

⁴ As of fiscal year 2012, the median contribution rates in systems covered by Social Security stood at 10.6% for employers and 5.7% for employees (both as a percent of pay). *Public Fund Survey, National Association of State Retirement Administrators (NASRA), November 2013*

underfunding by the plan sponsors. Contribution rates set in statute may have no relationship to the actuarially required contribution rate (ARC). Even if rates are not set by statute, many plan sponsors failed to pay the ARC as needed.⁵

After years of underfunding the retirement systems, plan sponsors were faced with increasing funding needs at the same time as budgets were constricted by the recessions. In many plans, the answer to increased contributions was to increase contributions paid by employees.

For many systems, the answer to stability did not rely solely on contributions. Reforms resulting in plan design changes have been enacted in almost every state. The majority of changes have been to basic elements of the retirement formula, such as: increasing the age for retirement, increasing years of service used in the final average salary of the benefit formula, and reducing the multiplier in the formula. While these changes have generally been applied to only new hires, they still have had a measurable impact of reducing expected liabilities. Common changes that have been applied to active members and retirees have been reductions in future cost-of-living adjustments.

In several states, the plan design reform has been to place new employees in a system other than the traditional defined benefit plan. New plans have generally been hybrid plans, but in several cases, the new plan has been either a cash balance plan or a defined contribution plan.

IPERS Case Study

The Iowa Public Employees Retirement System (IPERS) is a cost-sharing, multiple-employer defined benefit plan. Its 2,100 participating employers cover employees of the state, all school districts, counties, and cities in Iowa. Current membership is about 342,000 individuals⁶, about 10 percent of Iowa's population. IPERS pays out \$1.8 billion annually in benefits, of which 88% is paid in Iowa. IPERS' funded ratio, as of June 30, 2013, was 81percent.

In 2000, IPERS had a funded ratio of 98% when it encountered what was then called the perfect storm of pensions—increased liabilities due to updated mortality tables, market losses of the tech bubble, followed by contributions falling below the actuarially-determined rate. The funded ratio fell to 89% and remained stable at this ratio for several years, thanks to investment gains and some increases in contributions (although still below the actuarially-required amount).

The impact of the Great Recession of 2008-2009 resulted in a drop in the funded ratio to a low of 80 percent. In response to the lower funded ratio, the plan sponsor, the Iowa legislature, enacted governance and benefit reforms that took effect in 2012. In the area of governance, the determination of contribution rates to be paid by employers and employees⁷ was delegated to IPERS' trustees in accordance with the actuarial assumptions and methods adopted by the trustees. Fiscal year 2014 was the first year since 2001 that the actuarially-determined rate was paid.⁸

⁵ In an analysis of the *Public Plans Database* from 2005-2009, Alicia Munnell calculated that only 45% of plans received the full ARC. *State and Local Pensions, What Now?* Pg 82

⁶ Membership includes 165,000 active contributing members, 105,000 retired members, and 72,000 inactive members.

⁷ IPERS is one of the few public systems in which employee contributions are variable along with the employer contributions.

⁸ The underpayment of contributions added \$1.3 billion to the overall unfunded liability of \$5.8 billion.

Benefit reforms enacted were unique among public plans in that the reforms applied, to not just new hires, but also to future accruals of current active members. The primary reforms consisted of applying a full actuarially determined early retirement penalty for retiring prior to attaining normal retirement and changing the salary calculation in the benefit formula from a three year average to a five year average. The benefit reforms reduced the unfunded liability by \$674 million.

The combination of instituting a commitment to funding and reforming benefits stemmed further decline in the funded ratio and, along with positive investment performance, has allowed steady improvement in funding.

Conclusion

The challenges of sustaining public plans that are an attractive component of employee compensation and that offer retirement security are many, but they are not insurmountable. Regardless of the design, core elements that should be retained are: mandatory participation, employer and employee cost-sharing, pooled and professionally-managed investments, benefit adequacy, and mandatory annuitization.