LEGAL

Public Pension Plan Insights

Are all public pension plans in trouble? The answer is not as easy as it seems.

BY JOSEPH A. NICHOLS

Public pension plans are in my blood. My father was a plan trustee for a multiple employer state system in Missouri for 28 years. After meeting the system's actuary, I decided at age 16 that I wanted to become a pension actuary. In my second job out of college, the one in which I cut my consulting teeth, I worked 100% on public pension funds.

Over the years, I have expanded my pension experience beyond just the public plan marketplace, but I have kept my public pension consulting qualifications up to date. I say this to build a context for my comments — I have high regard for those protecting public pension plan benefits and feel that most are going about it in a more than admirable manner. However, I also feel that many of those protecting public pension benefits have their heels dug in and that there are certain changes that can be made to help secure benefits for future beneficiaries without putting undue burden on future taxpayers.

FUNDING ISSUES

Most public pension plans were put in place when there were fewer retirees and

the expectation was that tax bases, the workforce and salaries would increase indefinitely. These types of assumptions allow for funding a large portion of unfunded liabilities far into the future.

There is nothing inherently wrong with having unfunded liabilities. However, until recently, they were a small portion of the overall salaries, and positive market corrections tended to bring funding back into line rather painlessly — especially when assuming that higher future salaries would help pay the deficit. The 2008 recession not only created a drop in assets, but also shrank many public workforces and flattened payrolls. This came at a time when most public pension plans were at a mature level (more people receiving benefits than working), creating a "perfect storm" that put the issue front and center.

Many of the largest public pension plans are well funded on an ongoing, long-term cash flow basis. For example, based on the most recent public pension plan survey conducted by Milliman, just over half of the 99 large public plans surveyed had funded ratios over 70%. All but a few plans have adequate assets to pay full benefits for many years in the future.

However, the sustainability of plans is based on three very important assumptions:

- future investment returns average generally 7% to 8%;
- workforces remain at least stable; and
- plan sponsors contribute their Actuarial Recommended Contribution (ARC).

If these three assumptions are met, most public pension plans will rarely have a funding issue.

INVESTMENT ASSUMPTIONS

One of the most contentious arguments against public pension DB plans is that the funding calculations are based on an overly optimistic investment assumption.

The public plan position is that, based on historical information, the assumption being used is very reasonable. The contrarians say that there is too much risk inherent in the current assumptions. The pension plans state that since benefits are to be paid over the next 70 years, the risk can be spread out over an acceptable period.

> "There is no broad-brush stroke that can paint a picture of all public pension plans."

Who is right? It depends. How are the assets invested? Is there enough equity exposure to justify the current assumption? What is the inherent inflation assumption? What is the salary scale assumption? We have recently seen a unique period of low inflation (and small salary increases) with normal to high equity returns. Is this the new normal?

There is tremendous disagreement and misinformation about the "right" discount rate to value public pension plan liabilities. Many articles have been written on this topic alone. Based on my experience and after thoughtfully considering the existing data, studies and arguments, I believe an expected investment return approach is appropriate when selecting a discount rate for public pension plan funding valuations given the long-term nature of the plans.

The public plans with current (or very short term) cash flow issues are typically in trouble because of one reason: inadequate funding. As indicated above, the inadequate funding is either due to a decreasing workforce or the plan sponsor is not making the full ARC — but typically it is both.

Over the years, I have told Boards that I am less concerned about a plan that is 60% funded and is making the full ARC than a plan that is 90% funded with year-to-year funding deficits. It's the trend of the underfunding that is the most important factor.

For example, as of Dec. 31, 2013, the Firemen's Annuity and Benefit Fund of Chicago was only 27% funded (on a market value basis). Based on the most recent Consolidated Annual Financial Report, Chicago has contributed 44% or less of the ARC for the last 6 years.

There are many reasons why a public pension plan might have a deficit. However, the only way that a plan can be sustainable is to fund the ARC on a consistent and adequate basis.

OVERLY RICH BENEFITS?

Another contentious argument is that benefits being provided to public plan participants are too rich. I would agree that some are very rich — for instance, some public pension plan provisions allow for full retirement after only 30 years of service, or have a 2.5% annual benefit accrual factor. The plans argue that the rich benefits make up for lower salaries earned in the public sector. Contrarians argue that that is no longer a valid argument.

There are also some public pension plans with adverse selection — for example, final salary definitions with generous overtime and service buy-back inclusions. These provisions may have been put into place when overtime was limited, but have been kept unchanged as overtime policies changed. This allows participants close to retirement (with higher seniority) to boost overtime and spike the average salaries that are being used for determining benefit levels.

CONTRACT CLAUSE

Many public pension plans have altered abusive provisions such as spiking, but in most cases only for new employees. This leads to the

Continued on page 29 »

Educate your clients. Despite regular news reports about cybersecurity breaches, many people continue to hit "send" without thinking carefully about what they're sending and who might be affected by it. It's wise to teach clients not to use your work products for other than their intended purposes, not to send them to third parties without your express, written permission, and never to quote your work in part if it can only be understood in full. Consider putting appropriate controls on the use of your work in your engagement letters, and remind clients periodically about them.

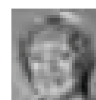
Encourage questions. If you think there's a risk that your client, or some authorized user, may misinterpret your work product, make an extra effort to encourage them to contact you for clarification.

Caveat your work product. Even if you give clients clear guidance on how to use your work, it's all too easy for e-documents to find their way into the wrong hands. Depending on the nature of the work product, it may be smart to include descriptions of who can use the work product and to what purpose, specific statements that the work is not to be altered, excerpted or misquoted, and directions on where to go for additional information or answers to questions. It's also important to satisfy Section 7's requirement to take reasonable steps to ensure that material in the work product is presented fairly and that the sources of the material are appropriately identified.

PDF your work products – and keep a copy. These days, there's no such thing as the electronic document that can't be digitally altered. Still, it's normally prudent to send work products in a format that makes tampering more difficult, and to keep copies of the originals for a reasonable time after you send them. Thankfully, secure digital storage is readily available, making stacks of dusty files a thing of the past. Consider putting a document retention policy in place if your firm doesn't already have one, and keep e-documents just as you would paper.

Train your staff. Inexperienced employees may be so accustomed to sharing information online in their personal lives that they don't consider how work products can be abused online. Put policies in place to prevent inappropriate transmission of data and work products, train your employees on them, and check periodically to make sure they've gotten the message.

Sony Pictures is a huge multinational corporation with, presumably, state-of-the-art cybersecurity systems. That hackers were able to break into Sony and generate such havoc proves that no one is completely safe online. However, with thought and care, pension professionals can reduce the risk that their work products will be misused, boosting client confidence and demonstrating their own professionalism. PC



Lauren Bloom is the General Counsel & Director of Professionalism, Elegant Solutions Consulting, LLC, in Springfield, VA. She is an attorney who speaks, writes and consults on business ethics and litigation risk management.

» Public Pension Plan Insights

(continued from page 27)

topic that many public pension plans hold dearly, but in my opinion, does more harm than good: the "contract clause."

Under the contract clause, in many states, the plan participants retain the right to all plan provisions in place at date of hire — for all past and future service. Because of the contract clause, changes to plan provisions that lower funding — and even ones that would eliminate provisions that are being abused — can only be made prospectively, for new employees. This roadblock provides some strong ammunition for the contrarians that state DB plans are too rich.

CONCLUSION

There is no broad-brush stroke that can paint a picture of all public pension plans. Many public pension plans operate in a manner that controls risk while providing a safe, secure and affordable benefit to millions of participants. The plans that are in trouble are the ones that have promised unreasonable benefits, allowed participants to game the system with outdated — and possibly even careless — provisions, failed to provide adequate investment oversight and did not make adequate contributions.

So the next time someone makes a statement that all public pension plans are in trouble, think about the potential issues and how, like most issues in our society, the answer is never as easy as it seems. PC

The views expressed in this article are those of the author(s) and are not necessarily the views of FTI Consulting, Inc., its affiliates, subsidiaries, management or its other professionals.

Joseph A. Nichols, MSPA, ASA, EA, MAAA, is the Senior Director, Pension Consulting Services, at FTI Consulting in Savannah, Mo. Joe has provided pension actuarial services to a wide range of plan sponsors for more than 25 years. He is the president-elect of ASPPA.