Report of the Blue Ribbon Panel on Public Pension Plan Funding

Emily Kessler, staff fellow, Society of Actuaries

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Agenda

- The Panel
- The current situation
- The Panel’s recommendations

Panel members

- Bob Stein, retired, Ernst & Young, chair
- Andrew Biggs, American Enterprise Institute, co-vice chair
- Douglas Elliott, Brookings Institution, co-vice chair
- Bradley Belt, Orchard Global Capitol Group and Palisades Capital Management
- Dana Bilyeu, formerly Nevada Public Employee Retirement System
- David Crane, Stanford University
- Malcolm Hamilton, retired, Mercer (Canada)
- Laurence Msall, The Civic Federation (Illinois)
- Mike Musuraca, Blue Wolf Capital Management
- Bob North, New York City Office of the Actuary
- Richard Ravitch, former Lt. Governor of New York
- Larry Zimpleman, Principal Financial Group

The Panel’s charge

- Assess the changing funded status of public pension trusts
- Develop recommendations to strengthen plan funding going forward.

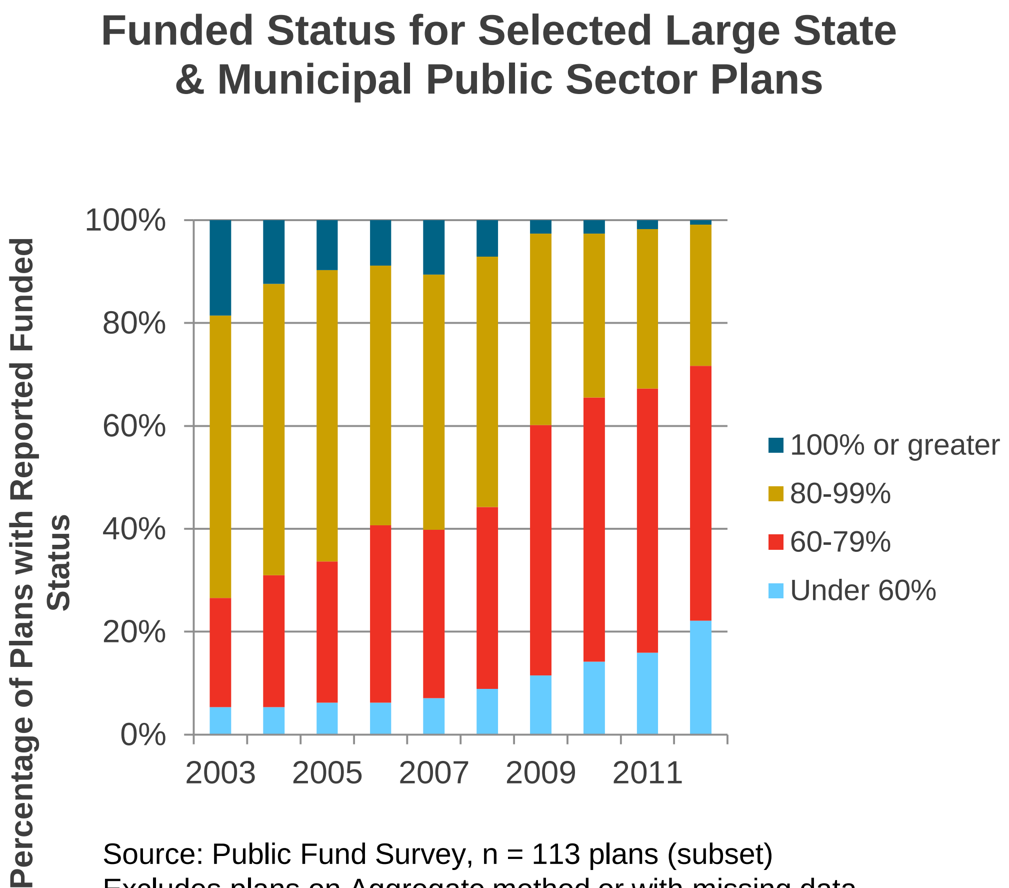
Panel findings

- Focus on funding: deliver on the benefit promises made to employees
- Funding principles…to guide recommendations
- Primary recommendations
  - Strengthen financial and risk management practices through new information to support decision making
  - Ask more of the actuary
  - Enhance system effectiveness

The current situation

Background

- Funded status: level and pervasiveness
  - 103% in 2000 to 73% in 2012
- Payment of contributions
  - Declining percentage of “expected contributions” paid



Source: Public Fund Survey, n = 113 plans (subset)
Excludes plans on Aggregate method or with missing data

Background

- Sponsor pressures
  - Contributions rising as % of payroll
- Investment in risky assets increasing
- Plan maturity
- US Public sector increased investment risk as plans matured

Background

- Funding assumptions and methods
  - Historical returns have met 8%, but current assumptions embed very high risk premia
  - Discount rates not followed market rates
  - Long amortization periods
- Impact of return volatility
  - Return volatility, inadequate returns and long amortization periods delay contributions

Panel findings

Funding concepts

- Adequacy
  - Fund to 100% of the value of promise
  - Fund based on median expected future investment outcomes
    - Assumed return should be achievable 50% of the time
  - Improve flexibility and resiliency to varying conditions (good and bad)

Funding concepts

- Maintain intergenerational equity
  - Restrain cost shifting to future generations
  - Strengthen discipline over funding process
  - Shorter periods are more effective (average remaining working lifetime)

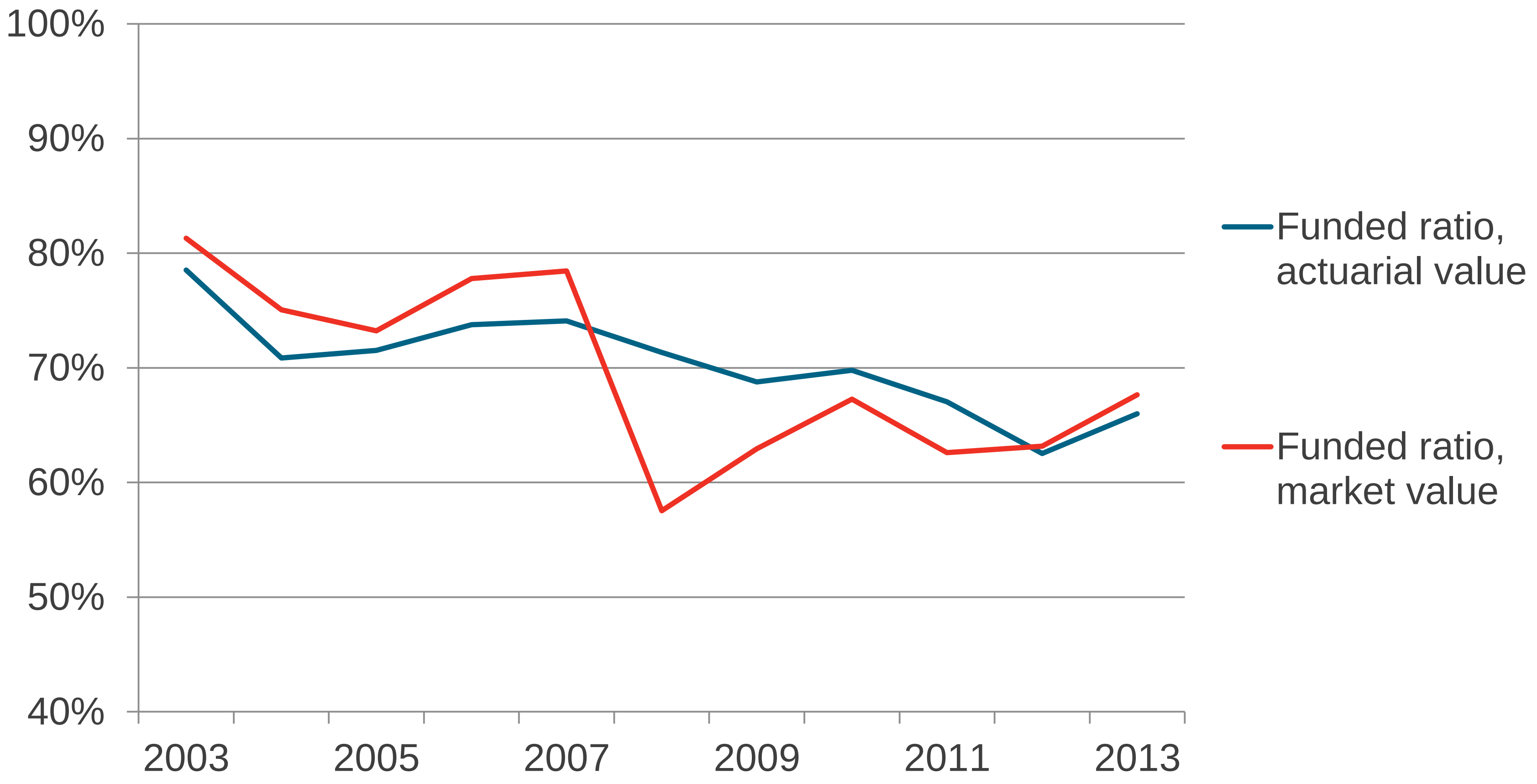
Funding concepts

- Program costs and budget predictability
  - Avoid equating ‘predictable’ with ‘low’
  - Investment in risky assets is incompatible with stable costs, particularly for mature plan
  - Need better forecasting methods

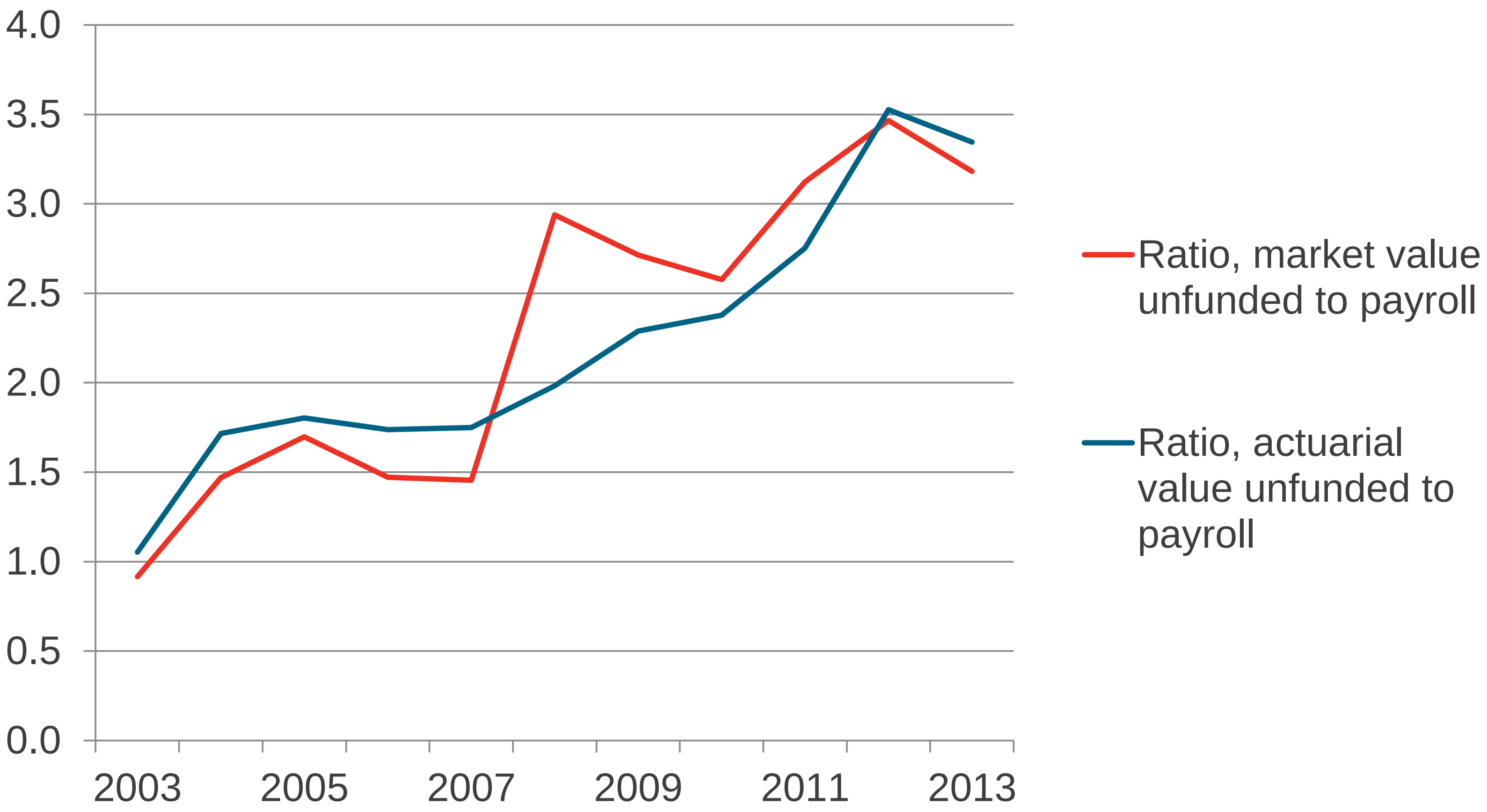
Recommendations: Risk and financial measures and disclosures

- Trends in key financial measures
  - Plan maturity
  - Plan cost
- Measures of risk position
  - Investment risk
    - Portfolio standard deviation
    - Plan liability and normal cost at risk free rate
  - Aggregate risk - Standardized contribution
  - Stress testing

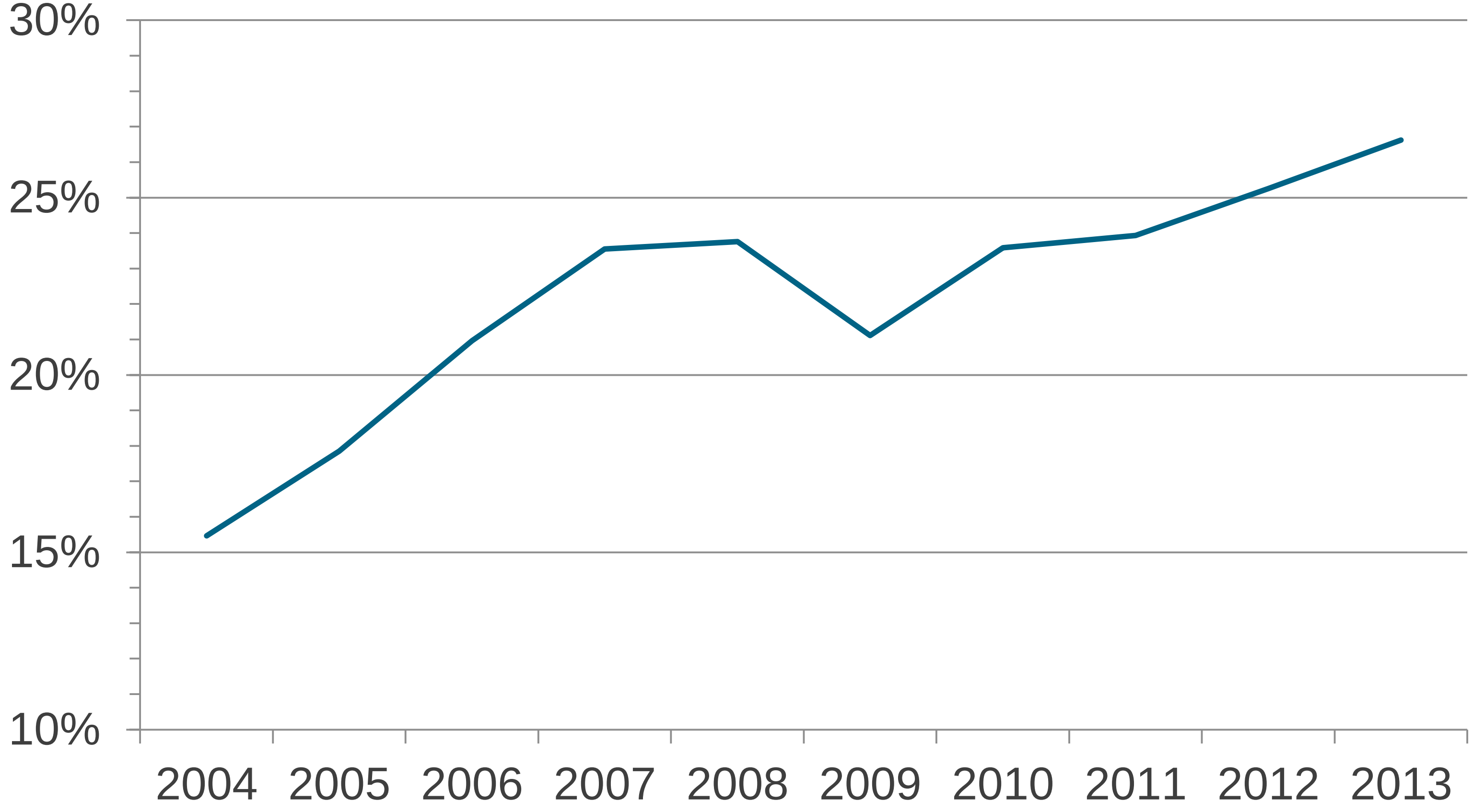
Funded ratios



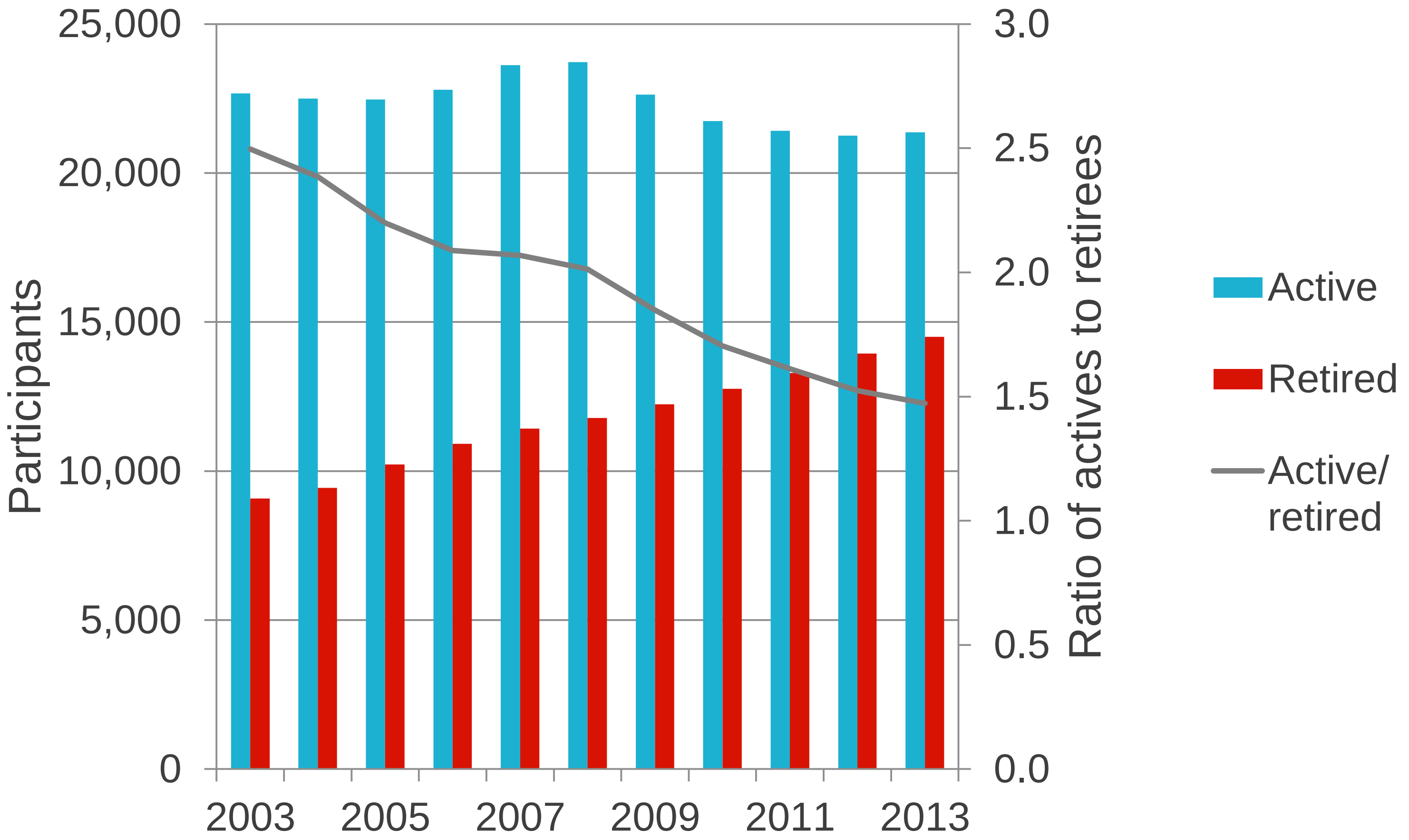
Unfunded liabilities to payroll



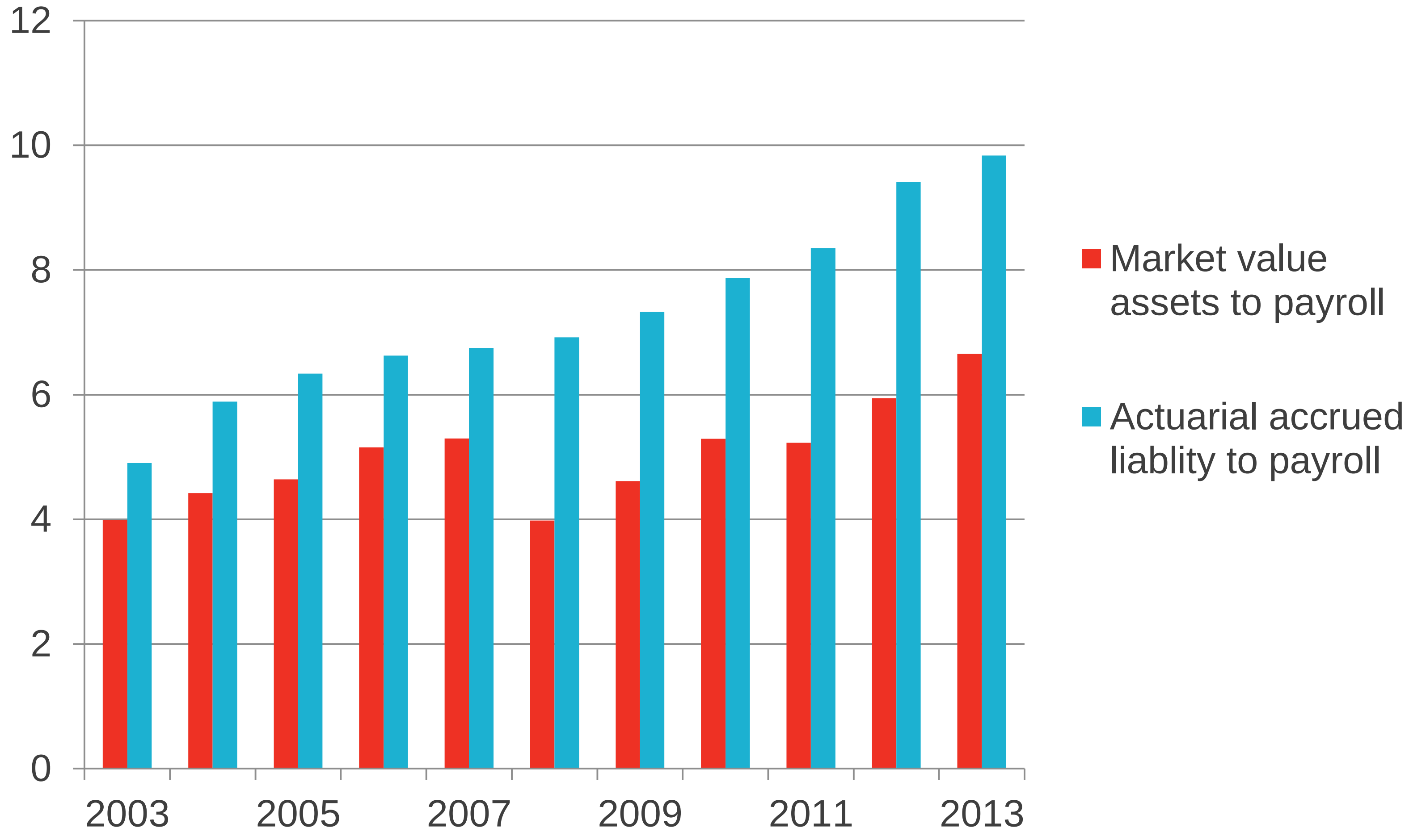
Employer contribution rate (as a percentage of payroll)



Maturity of participants

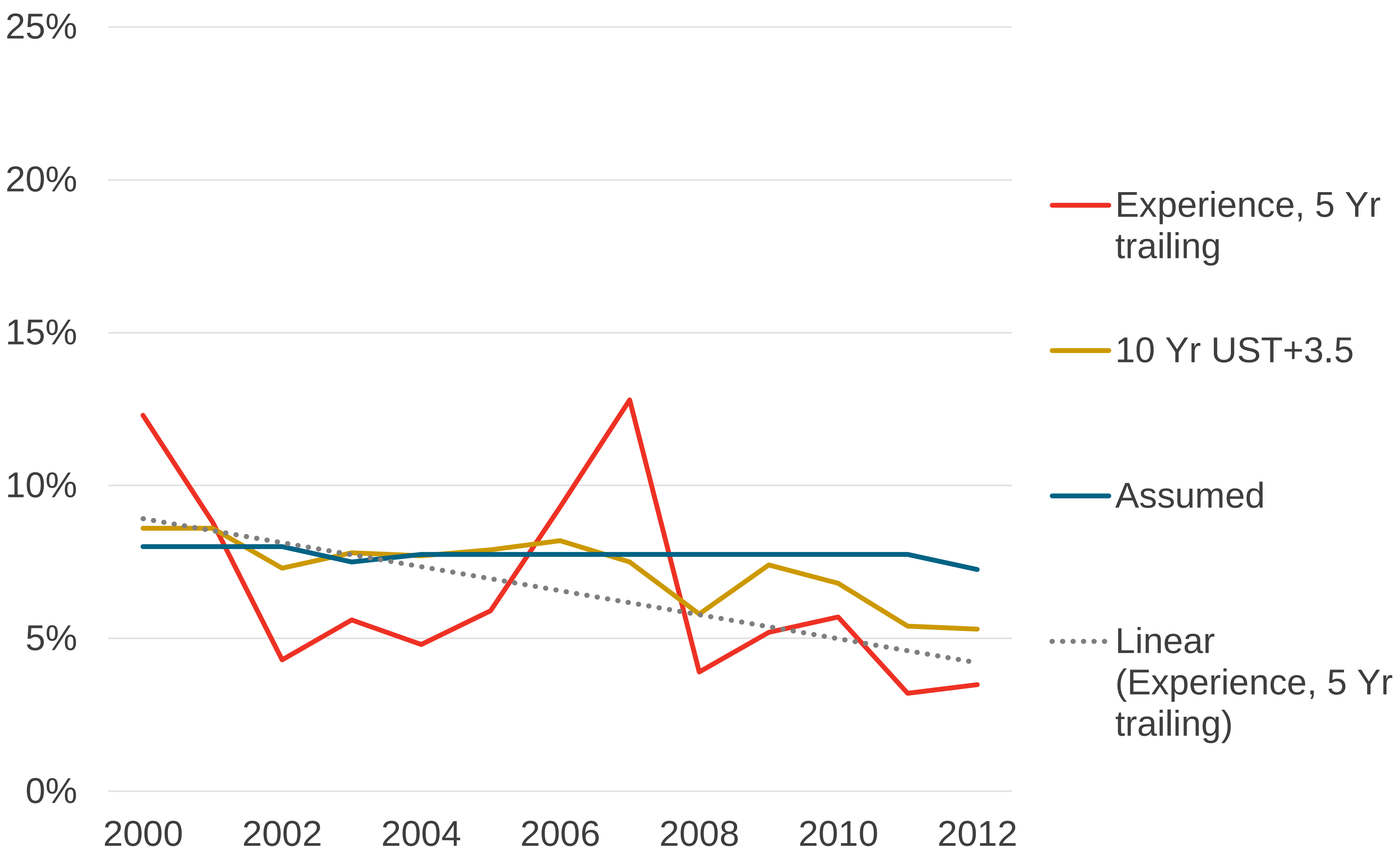


Ratio of assets/liabilities to payroll



Investment experience

Investment experience

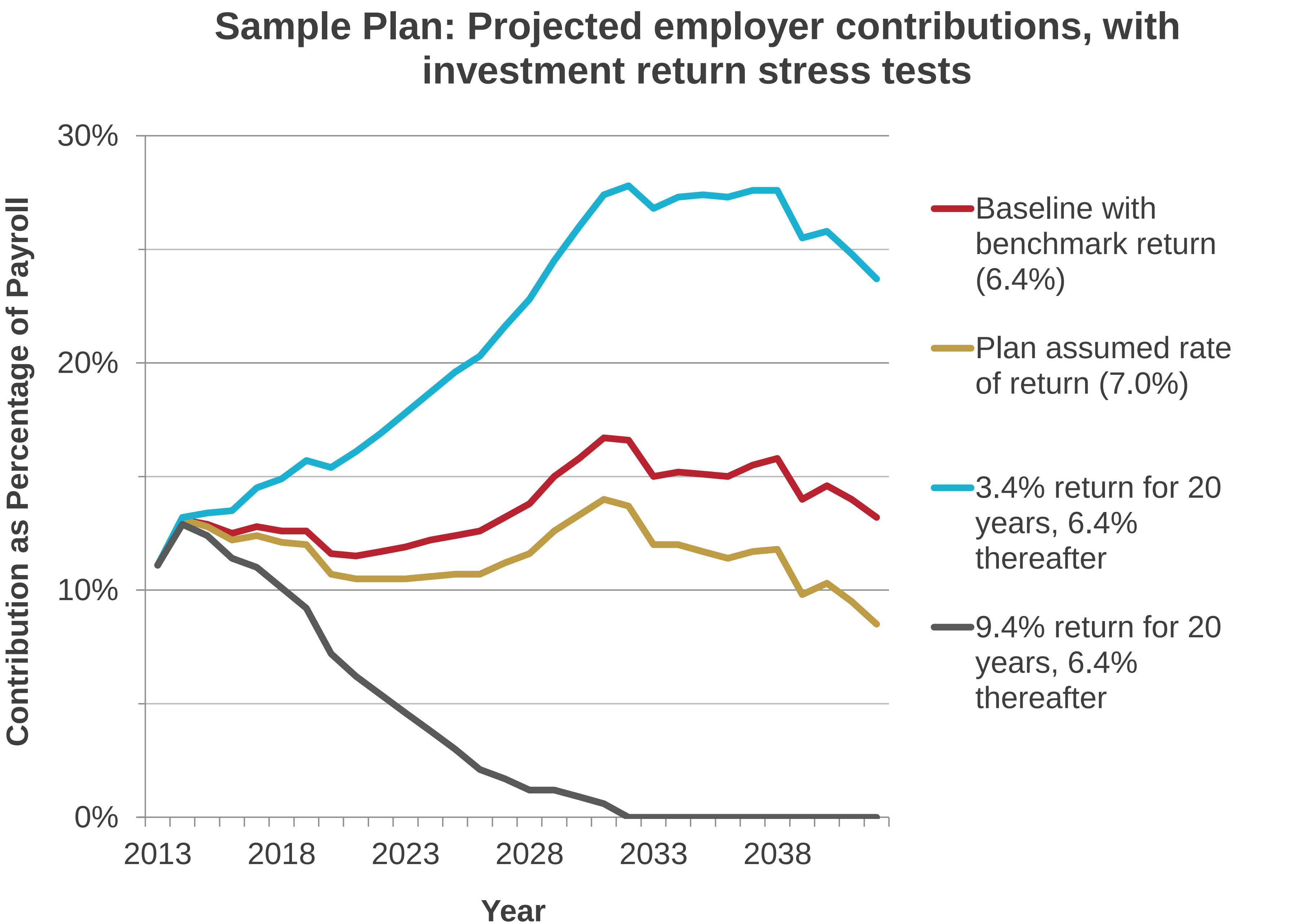


Measures of risk position

- Portfolio expected standard deviation
- Plan liability and NC at risk free rate
  - Measure of investment risk assumed
- Standardized contribution
  - Benchmark recommended contribution to assess funding risks
  - Adjust economic assumptions, funding methods to be consistent with Report’s funding principles

Stress testing

- 30-year projection, 20 years of "stress"
  - Plan assumptions
  - Baseline: standardized rate of return (6.4%)
  - Illustrate contributions, funded status
- Effect of paying only 80% of recommended contribution for 20 years
- Effect of investment return 3% greater or 3% less than expected over 20 years


Sample Plan: Projected employer contributions, with investment return stress tests
Contribution as Percentage of Payroll
30%
20%
10%
0%
2013
2018
2023
2028
2033
2038
Year
Baseline with benchmark return (6.4%)
Plan assumed rate of return (7.0%)
3.4% return for 20 years, 6.4% thereafter
9.4% return for 20 years, 6.4% thereafter

Role of the actuary

- Actuary to opine on reasonableness of funding assumptions and methods
- Disclosure
- Assumptions and methods
  - Discount rate (forward looking)
  - Amortization periods (15 – 20 years)
  - Asset smoothing (5 year)
  - Direct rate smoothing

Plan governance

- Governance structures should maximize likelihood that recommended contributions are paid
- Risk analysis capability of trustees
- Trustee training and experience
- Careful consideration of plan changes

Questions