

Virginia House of Delegates Appropriations and Finance Committees

Public Pensions: Introduction and 50-State Overview

November 18, 2015

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Public Sector Retirement Systems Project**

The Pew Charitable Trusts

- More than 40 active, evidence-based research projects
- Projects include public safety, immigration, elections, transportation, pensions, and state tax incentives
- All follow a common approach: data-driven, inclusive, and transparent

Pew's Public Sector Retirement Systems Project

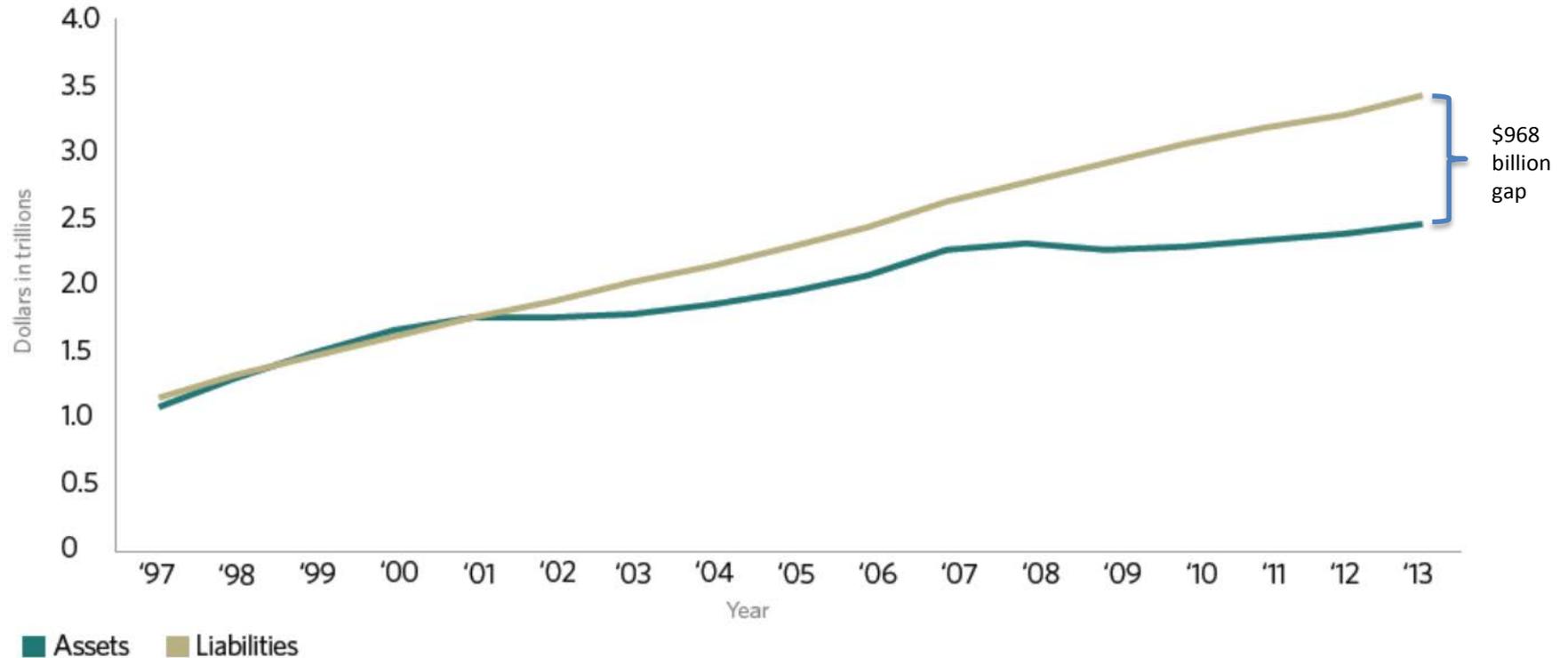
- Research since 2007 includes 50-state trends on public pensions and retiree benefits relating to funding, investments, governance, and employee preferences
- Technical assistance for states and cities since 2011

Overview

- Pension Funding – 50 State Summary
- Pension Investments – Recent Trends and Emerging Issues
- Update on State Pension Reforms
- Retiree Health Care Benefits (OPEB)
- Principles for Fiscal Sustainability and Retirement Security

Pension Funding – 50 State Summary

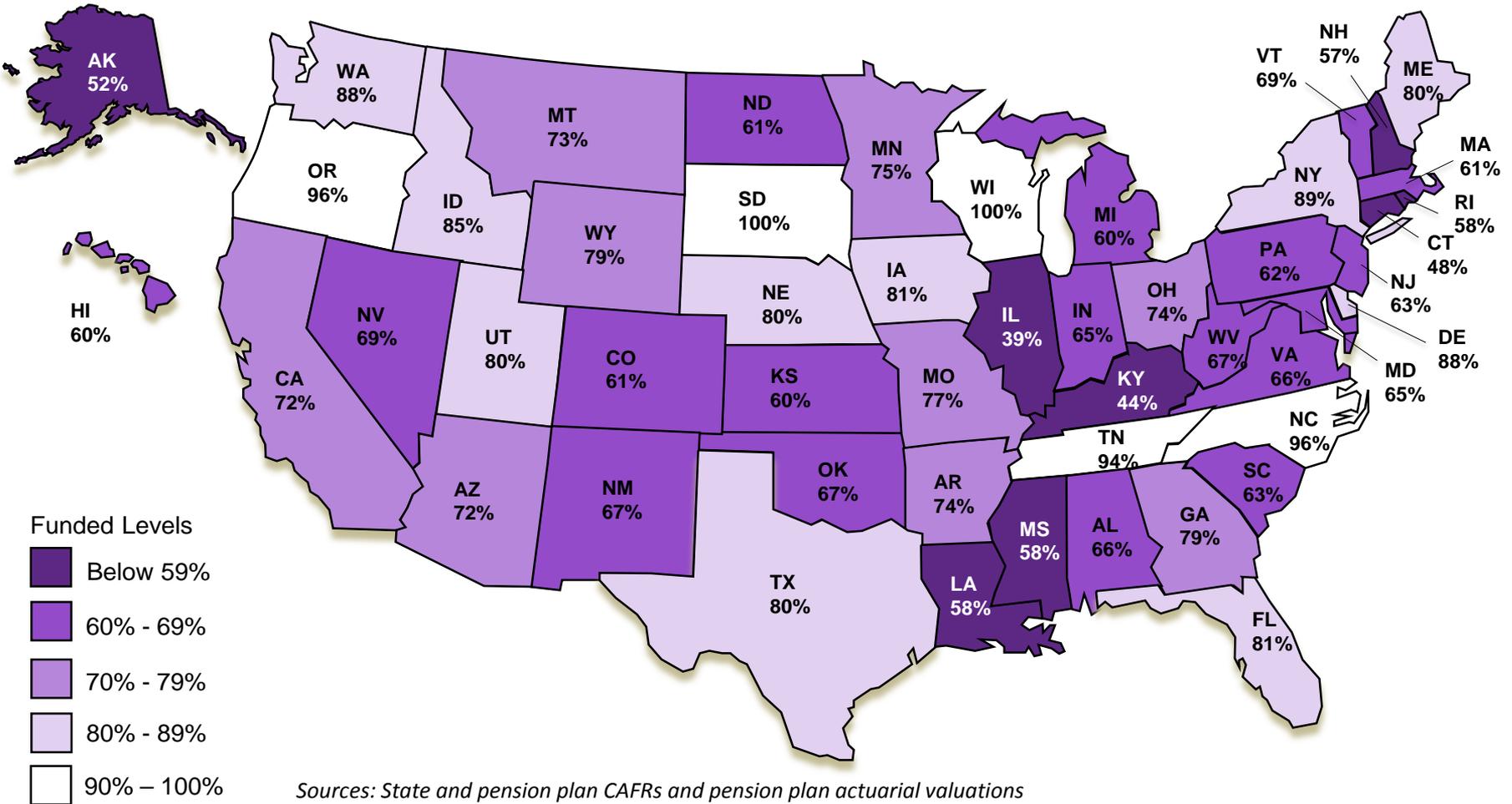
State Pension Funding Gap (Aggregate of 50 States)



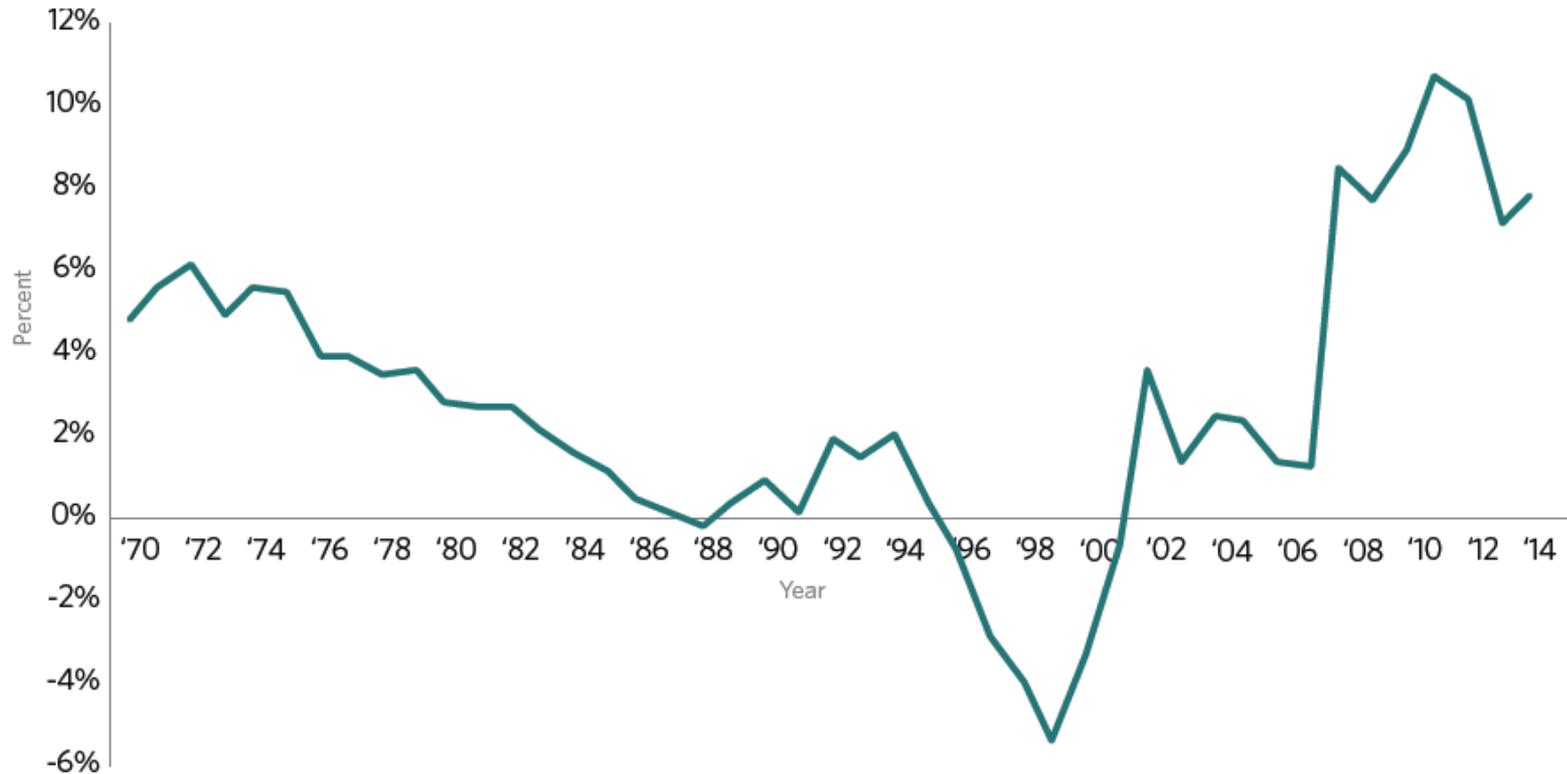
Sources: State and pension plan CAFRs and pension plan actuarial valuations

2013 Funded Ratios Across the 50 States

Overall, state pensions are 72% funded.

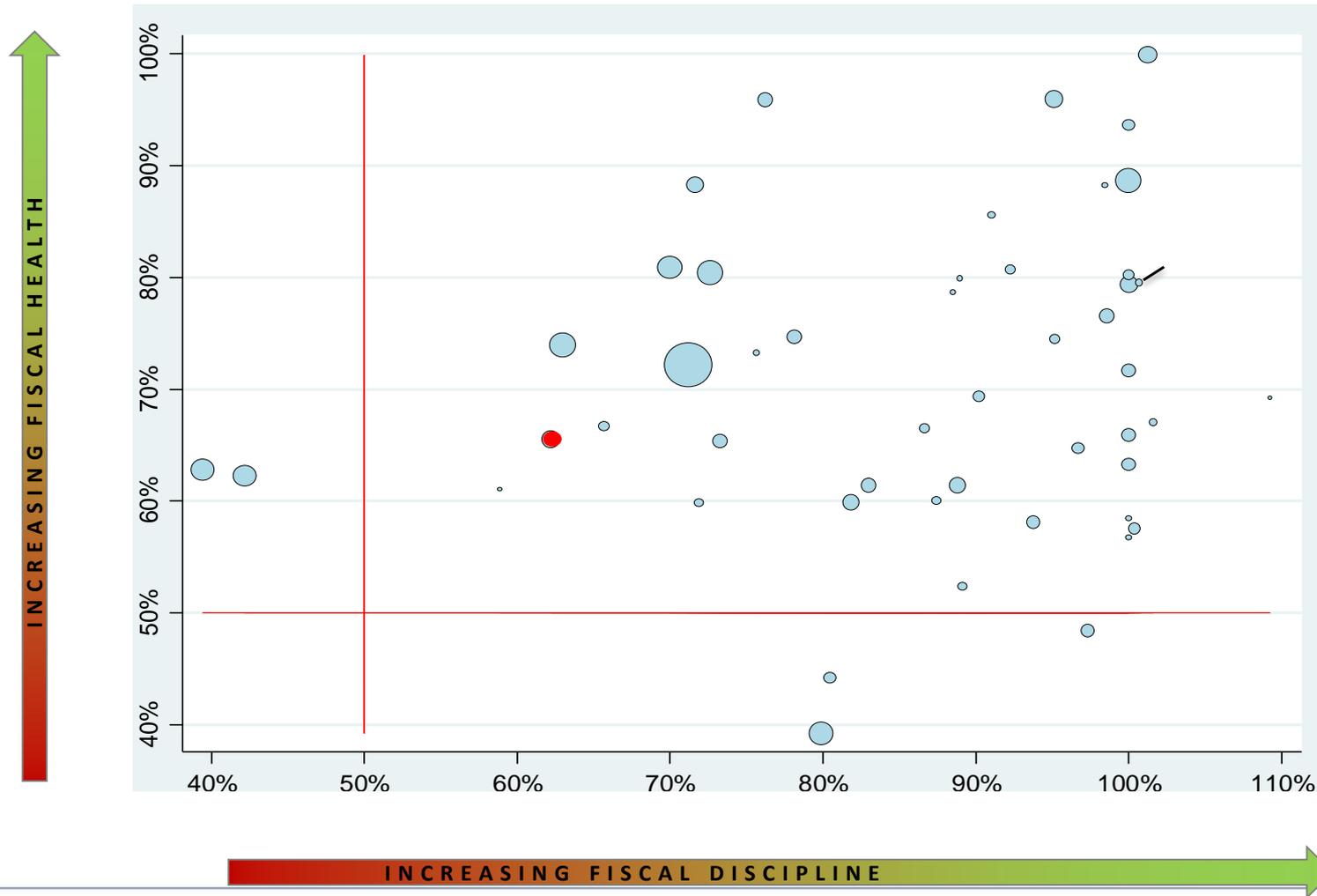


State and Local Pension Debt as a Share of Gross Domestic Product



Sources: *The Federal Reserve and U.S. Department of Commerce Bureau of Economic Analysis*

Fiscal Health and Discipline Across States



Funding Policy

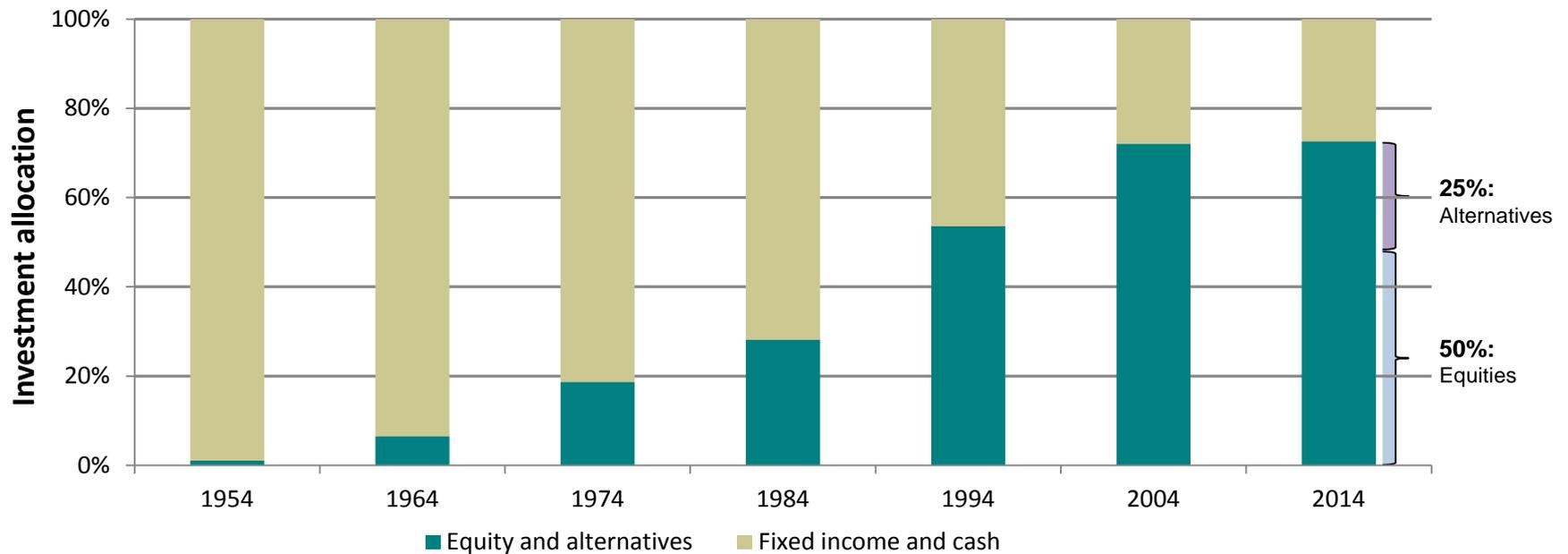
- Meeting Minimum Actuarial Contribution Standards
 - Over half of states continue to fall short
 - Several states recently committed to full actuarial required contribution (ARC) (CT, CA, KY)
 - Other states began making full ARC payments in the '90s and have seen funding levels improve (ME, WV)
- Calculating the ARC
 - ARC doesn't always signal true fiscal health
 - Common approach often fails to pay down debt and allows unfunded liabilities to grow:
 - 30-year
 - Open amortization
 - Back-loaded contribution policy
 - The Society of Actuaries and rating agencies have noted ARC limitations
 - Alabama and Arizona recently strengthened contribution policies
- Assessing Contribution Policy Going Forward
 - New GASB reporting standards will eliminate the ARC as a required disclosure while providing additional data points that give a better perspective on changes to assets and liabilities
 - Opportunity to look at new measures of contribution policy

Pension Investments – Recent Trends and Emerging Issues

Investments – Key Trends: More in Stocks and Less in Bonds

Public Pension Investments, 1954-2014

Allocations to equities and alternative investments have increased, while those to fixed-income investments have declined

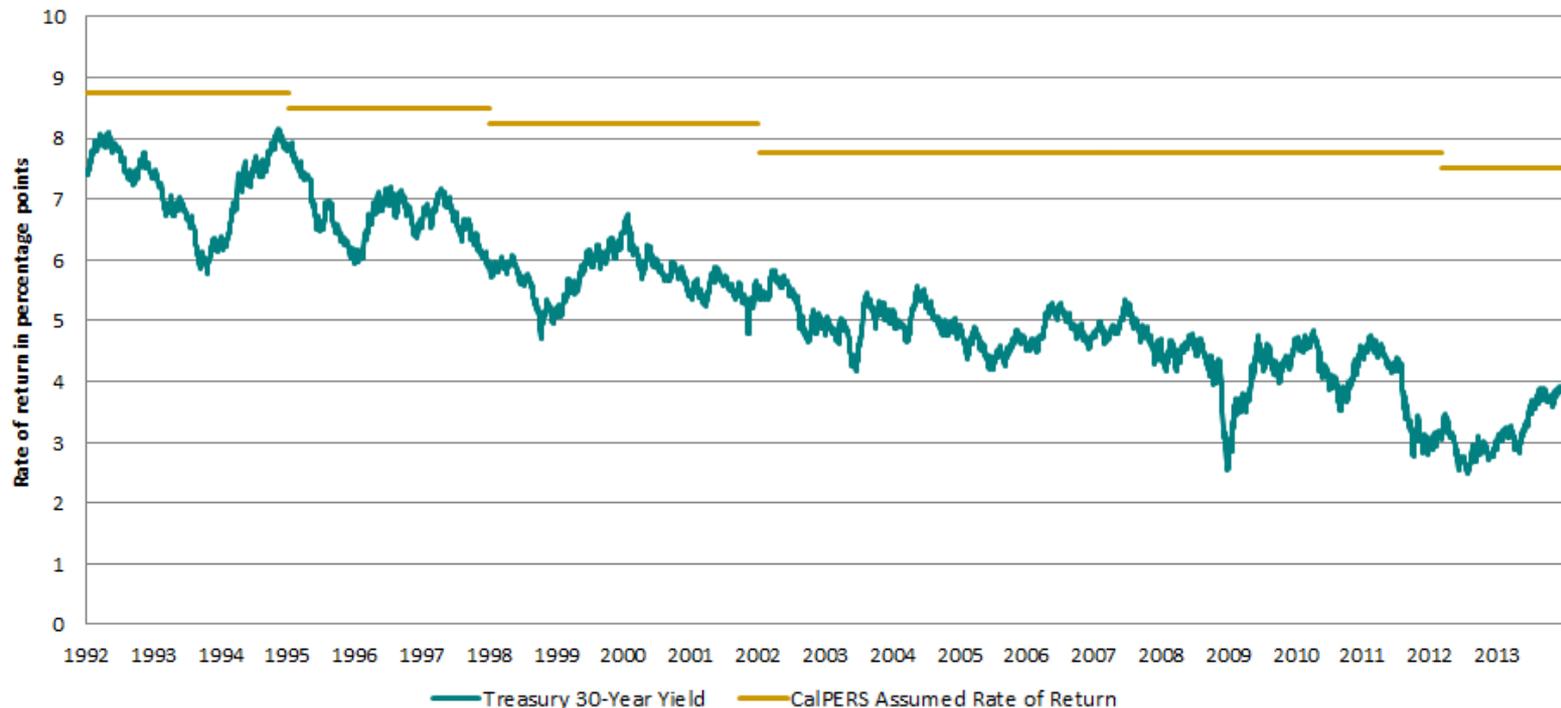


Source: U.S. Board Of Governors of the Federal Reserve System, *Financial Accounts of the United States*, 1954 to 2014; Pew Analysis of State Financial Reports ©2014 The Pew Charitable Trusts

Investments – Key Trends: Increased Risk Premium

CalPERS' Increasing Risk Premium

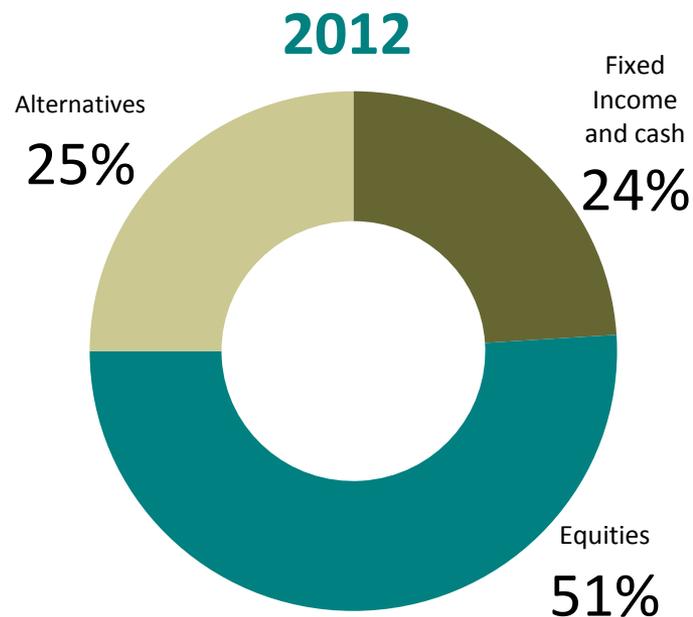
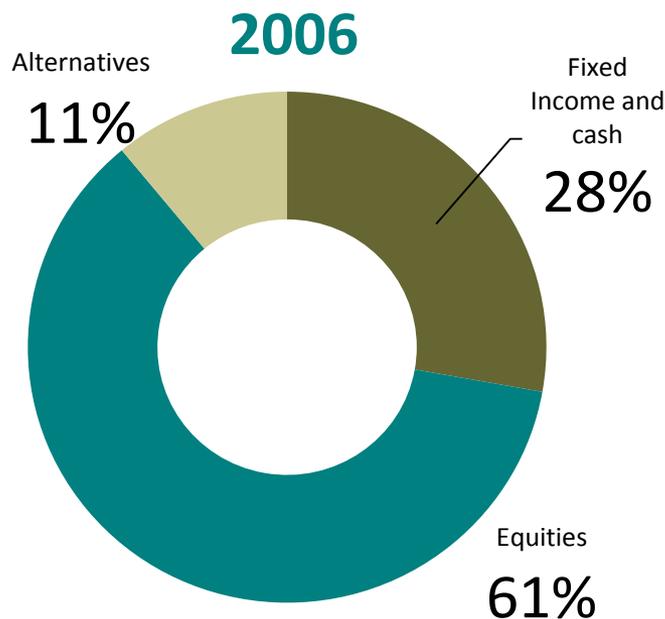
Plan's assumed rate of return remains relatively stable, while bond yields have declined



Source: Analysis by the Pew Charitable Trusts of U.S. Treasury data and CalPERS' Comprehensive Annual Financial Reports
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Investments – Key Trends: Increased Use of Alternatives

Public Pensions Include More Alternative Investments
Share of pension assets in alternatives has more than doubled



Source: Analysis by the Pew Charitable Trusts of State Comprehensive Annual Financial Reports, Public 100, and the Federal Reserve Financial Accounts of the United States
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Investments – Key Trends:

- Asset allocations have undergone a tremendous shift from safe and simple to riskier and more complicated over last 50 years.
- Trends toward more complicated, riskier, and costlier investments underscore the importance of good governance and transparency to keep pace.
- Policymakers need to balance returns, risks, and costs.
- Sensitivity analysis looking at the impact of investment shortfalls on plan funding and contributions is an important metric for policymakers.

Foundations of Investment Transparency

- Clear and Detailed Online Statement of Investment Strategy
- Investment Performance Reporting
 - Overall returns reported both net and gross of fees and other investment expenses
 - 1-, 3-, 5-, 10-, and 20-year return data
 - Returns presented by asset class
 - Reasonable benchmarks for overall portfolio and by asset class
- Fee Transparency
 - Overall fees, including any performance fees or indirect fees
 - Fees by asset class

Fiduciary Protections

- Increased complexity, risk, and cost of pension fund investments suggests need for increased clarity in fiduciary protections for plan beneficiaries.
- The Uniform Management of Public Employee Retirement Systems Act, or the Model Act, was legislation developed in 1997 with the goal of an ideal pension fund governance structure. The Act has 9 key provisions.
- This is just one potential framework for approaching governance and fiduciary responsibilities.
- While many protections existing in legal decisions across states, using explicit statutory language to defined fiduciary rules increases clarity for plan administrators, board members, and participants.

Key Fiduciary Provisions of the Model Act

Fiduciary Element	States Adopting
Prudence requirement	50
Exclusive purpose of providing benefits	27
Solely in the interest of participants	26
Reasonable administrative expenses	22
Diversification of investments	27
Economically targeted investments first prudent	8
Impartially for different participants	6
Appropriate and reasonable costs	4
Good faith interpretation of law	6

(Based on preliminary review of state statutes and constitutions)

Society of Actuaries Recommendations

From the Blue Ribbon Panel on Public Pension Plan Funding:

- Governance systems should encourage payment of recommended contributions and disclosure of a plan's financial information, and discourage use of funding instruments that increase risk or delay cash funding.
- Sufficient information and institutional structures to analyze risk, including guidelines on appropriate levels of risk for trustees.
- Access to appropriate education and training for trustees.
- Careful consideration of plan changes.

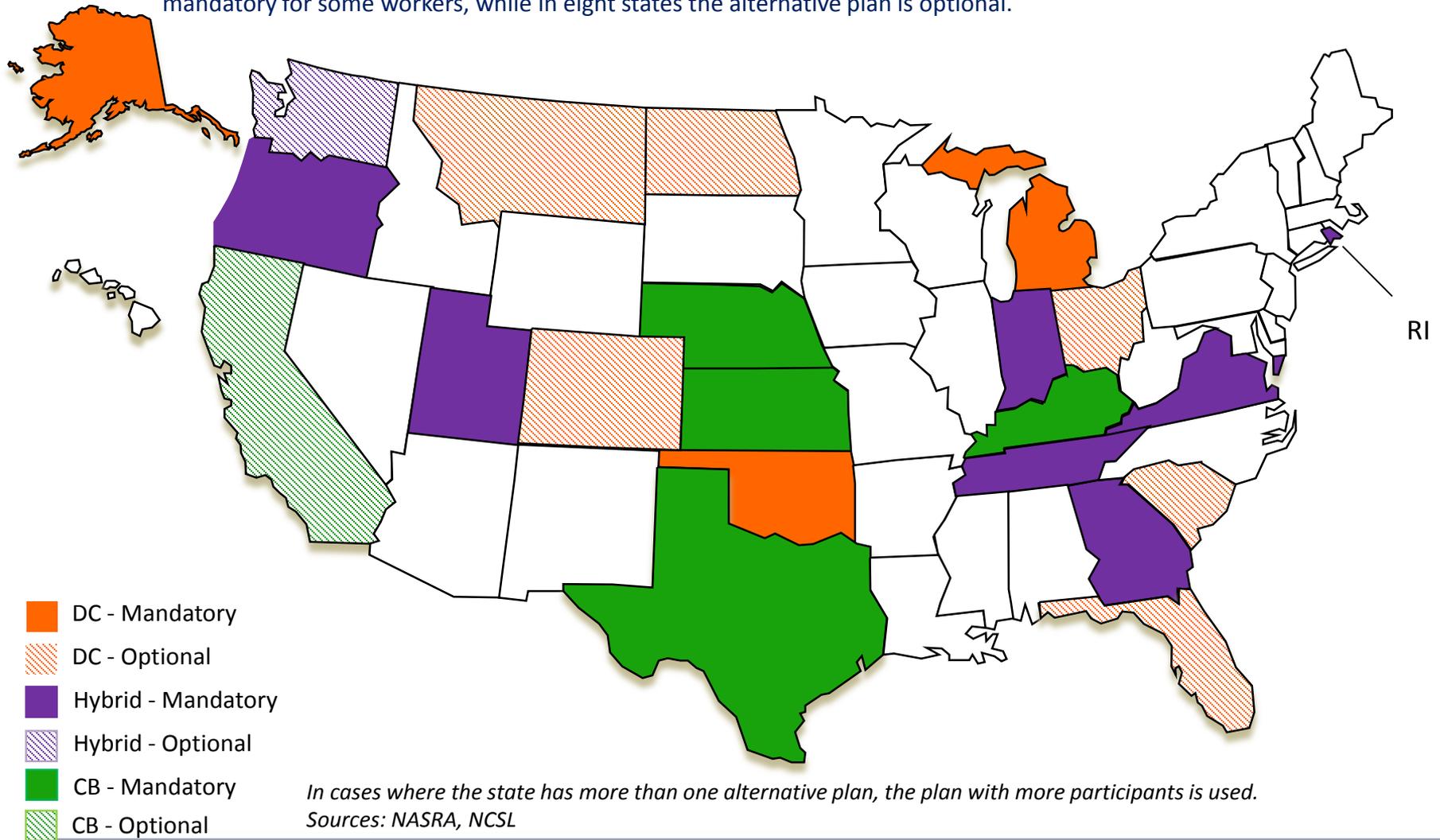
Update on State Pension Reforms

Summary of Recent Reform

- 48 states have implemented some kind of reform between 2009 and 2013.
- Many reforms changed plan provisions for new workers, but kept the basic structure of the plan.
- A number of states passed reforms that affected current workers or retirees between 2009 and 2013:
 - 15 states reduced COLAs for active and retired employees.
 - 7 reduced COLAs for active employees only.
 - 24 states increased employee contributions for current members.
- 9 states passed reforms that changed the benefit design for new employees. Overall, 22 states have an alternative benefit design.

States with alternative public sector retirement plans

Twenty-two states have implemented an alternative plan for some workers. In fourteen states, the alternative plans are mandatory for some workers, while in eight states the alternative plan is optional.



Most Common Example of Hybrid Plan Is Side-By-Side DB/DC Design with 1% Multiplier for DB*

	DB Multiplier	Employee cont. to DB	Employer cont. to DC	Default employee cont. to DC	Number of investment options	Annuity offered for the DC
Georgia Employee's Retirement System	1%	1.25%	3% (3% matching, 0% mandatory)	5% (optional)	21	No
TN Consolidated Retirement System	1%	5%	5% (0% matching, 5% mandatory)	2% (optional)	26	No
Rhode Island Employee Retirement System (state and teachers)	1%	3.75%	1% (0% matching, 1% mandatory)	5% (mandatory)	23	Yes
Virginia Retirement System	1%	4%	3.5% (2.5% matching, 1% mandatory)	1% (mandatory)	21	Yes
Washington Department of Retirement Services	1%	None	None	5% (mandatory)	13	Yes
Federal Government Retirement System	1%	0.8%	5% (4% matching, 1% mandatory)	3% (optional)	10	Yes

*See Pew primer on hybrid plan design: www.pewtrusts.org/pensions

*Original analysis and additional context initially provided in June 16, 2014 letter to the PA Senate Finance Committee

*Federal Government hybrid plan was implemented in 1986

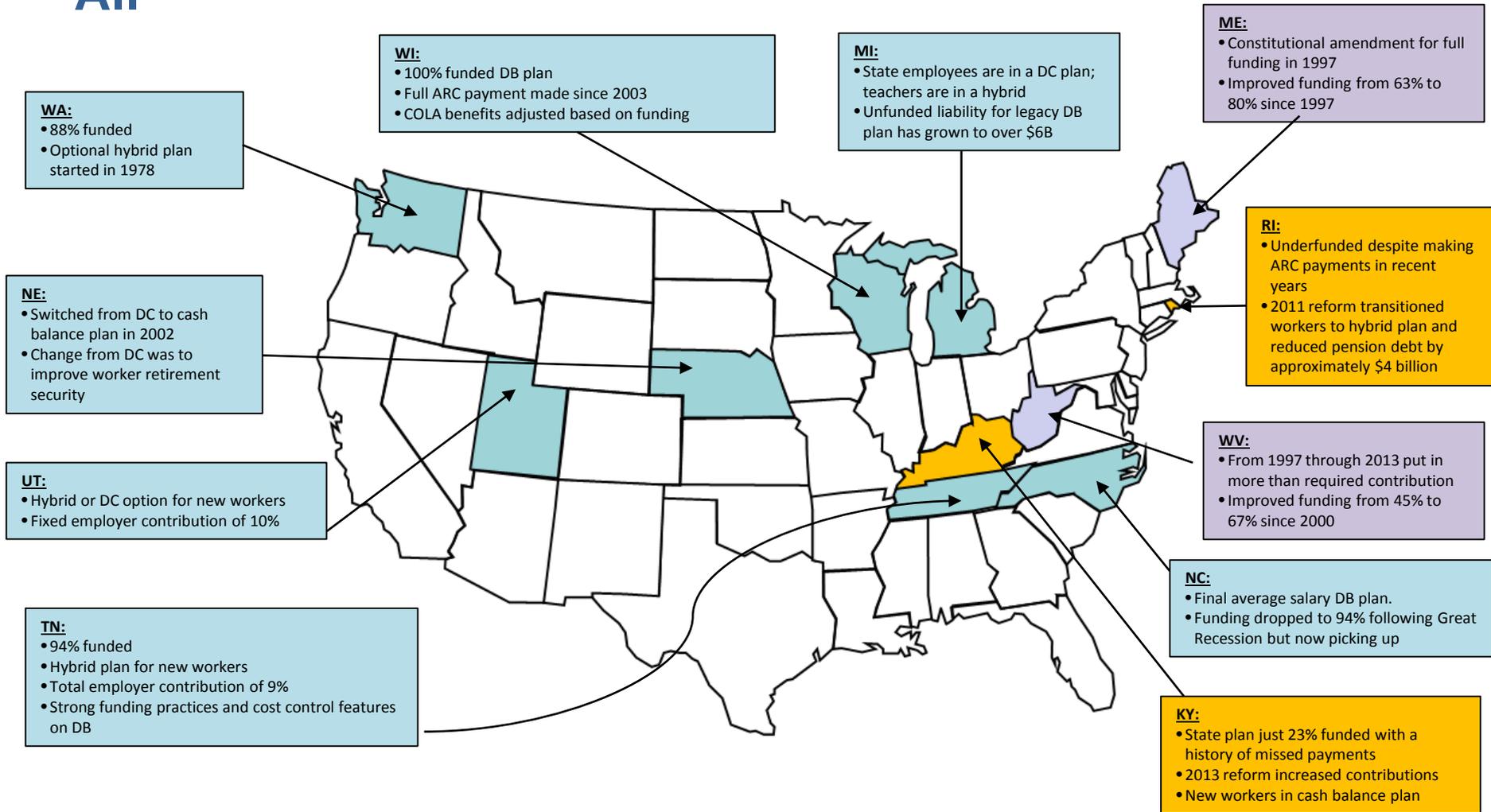
Summary of Recent Virginia Reforms

- In 2012, Virginia passed HB 1130 and SB 498, which created a mandatory defined benefit and defined contribution hybrid retirement plan.
 - Defined benefit plan with 1% multiplier.
 - Employees contribute 4% of salary to the defined benefit portion and a mandatory 1% to the defined contribution component. Employees can also contribute an additional voluntary contribution of up to 4% to the defined contribution.
 - Employers contribute at a minimum 1% to the defined contribution component and with matching can contribute up to a total of 3.5%. Employers also currently contribute an actuarially determined amount to the defined benefit portion (estimated 1.17%).
 - Capped COLAs at 3% for new hires and those not vested by January 1, 2013.
 - SB 497 was also passed, requiring local employees to contribute 5% of salary.
- 2015 legislation (HB 2178/SB 1162) allows school divisions the ability to elect to use 403(b) plans for the voluntary portion of the hybrid plan, and the Virginia Retirement System developing a cash balance plan proposal (HB 1969).

Policymaker Considerations in Plan Design

- **Retirement Security**
- **Recruitment and Retention**
- **Cost**
- **Cost Predictability**

Pension Promises in Other States – No One Size Fits All

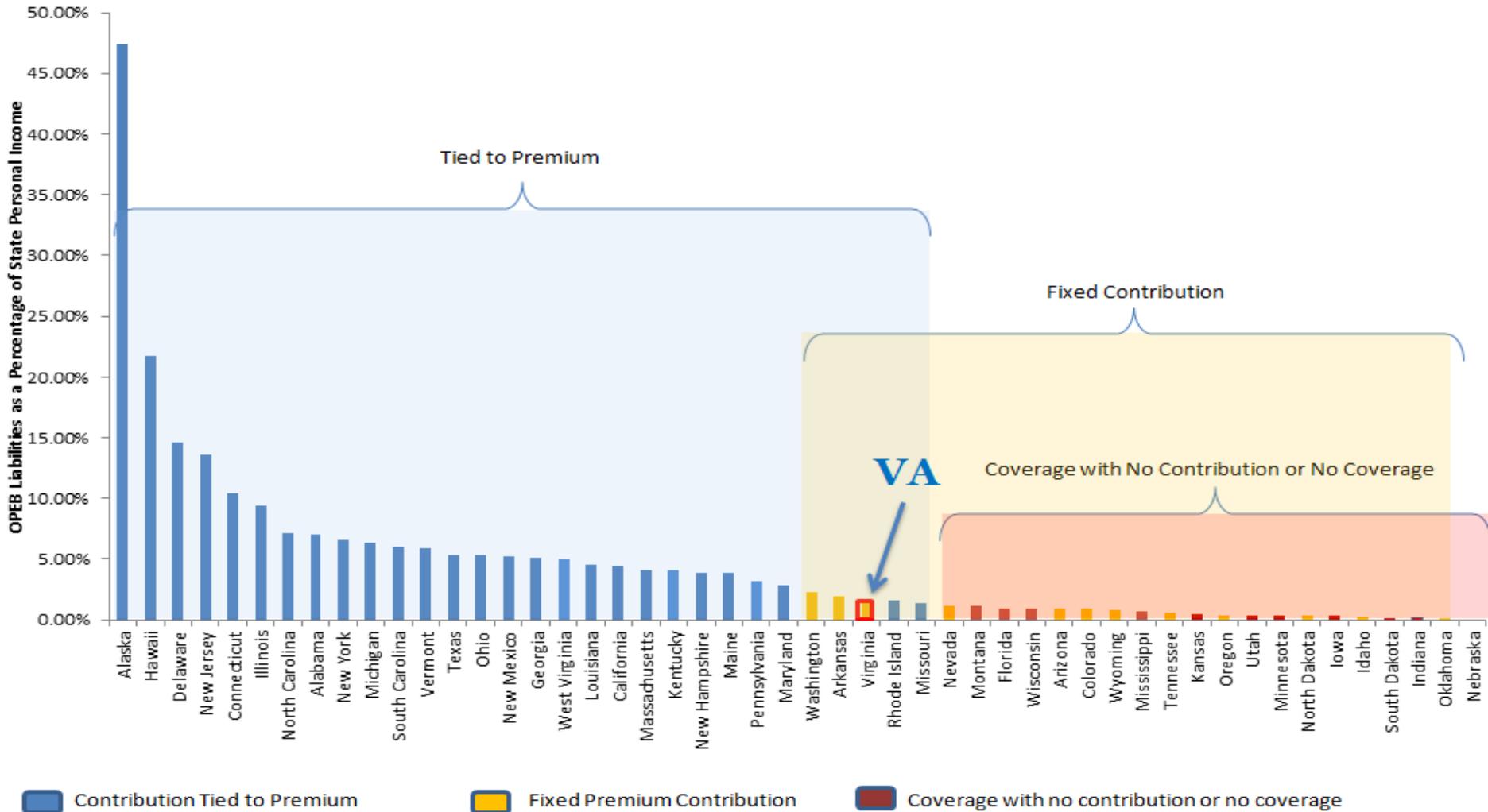


Key Takeaways from Other States

- **There are no panaceas:** Fiscal health and retirement security depend on funding policy and practices. Even well-funded states have taken steps to improve. Changes to plan design for new workers does not address current unfunded liabilities.
- **Increased attention to managing investment risk and fees:** CalPERS, Dallas Police and Fire, and Montgomery County, Pennsylvania
- **No one-size-fits-all approach on benefit design:**
 - DB plans with substantial employee risk-sharing (AZ, WI)
 - Side-by-side hybrid with DB and DC components (GA, OR, RI, TN, UT, VA)
 - Cash balance plans for new employees (KS, KY, NE)
 - DC plans (AK, MI, OK)
 - Recent / Current examples in cities: Atlanta, Jacksonville, Memphis

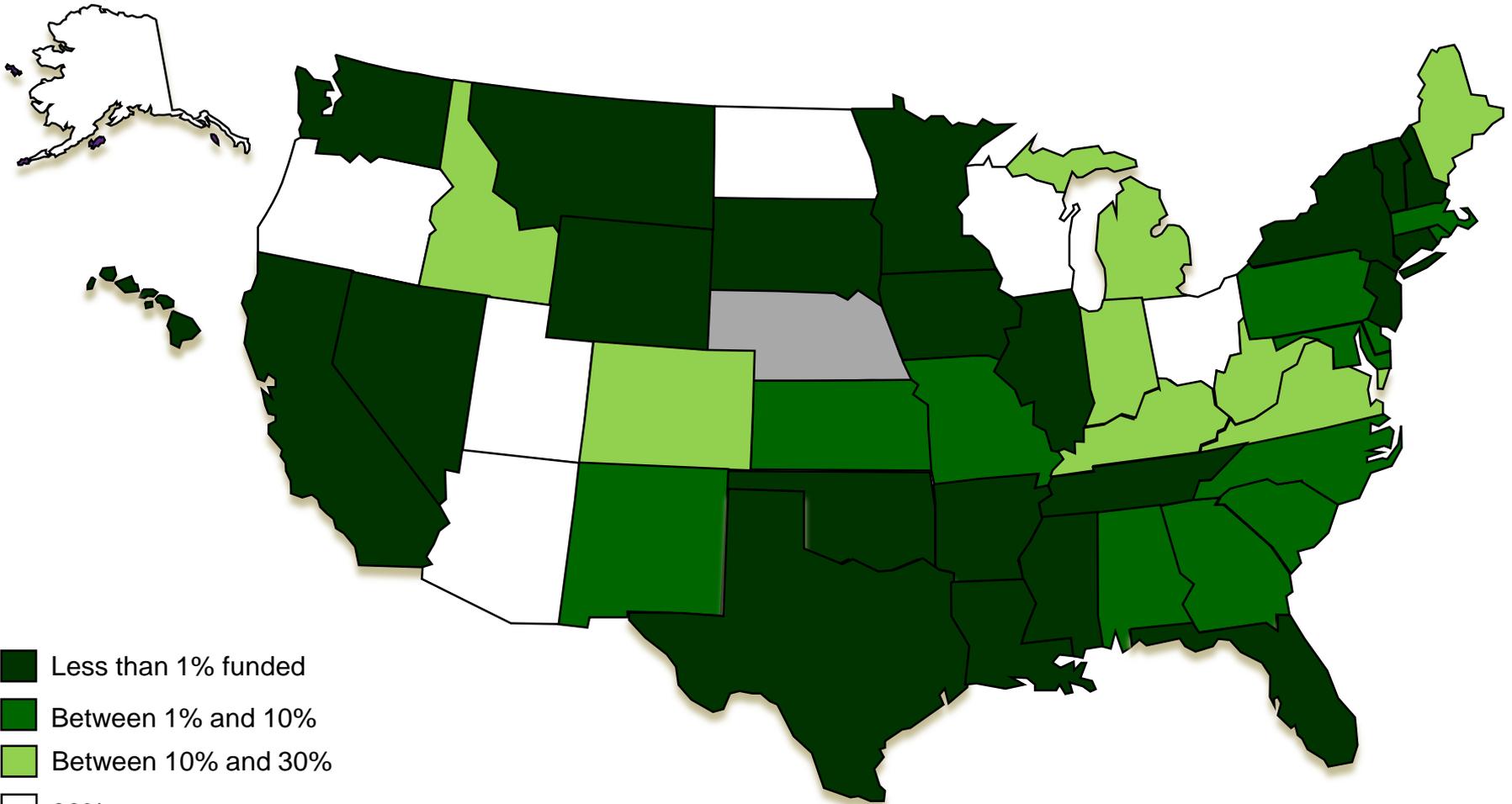
Retiree Health Care Benefits (OPEB)

Retiree Health (OPEB) Obligations



Sources: State CAFRs. OPEB actuarial valuations, and plan documents

2013 OPEB Funded Ratios Across the 50 States



Sources: State CAFRs. OPEB actuarial valuations, and plan documents

Principles for Fiscal Sustainability and Retirement Security

Retirement Security Principles

No one-size-fits-all solution, but **key principles** can guide any reform process.

- **Fiscal sustainability principles**

- Commit to fully funding and paying for pension promises.
- Manage investment risk and cost uncertainty.
- Follow sound investment governance and reporting practices.

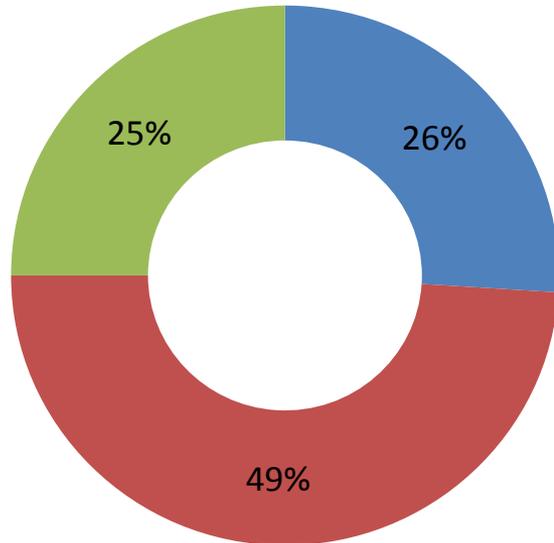
- **Retirement security principles**

- Target sufficient contributions and savings to help put employees on a path to a secure retirement.
- Invest assets in professionally managed, pooled investments with low fees and appropriate asset allocations.
- Provide access to lifetime income in retirement.

Appendix

Investments – Asset Allocations

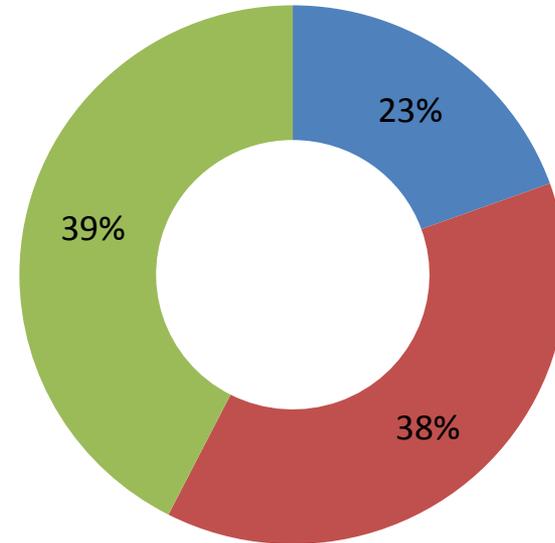
US States - FY13 Average Asset Allocation



■ Fixed Income/Cash ■ Equity ■ Alternatives

VRS - FY13 Asset Allocation

Paid \$305 million in management fees – 54 basis points on assets under management



■ Fixed Income ■ Equity ■ Alternatives

VRS alternatives include 8.6% in private equity, 6% in hedge funds, 9.4% in real return/real estate, and 15% in other alternatives.

Source: VRS 2013 CAFR

Virginia Retirement Systems

- Virginia Retirement System (VRS)
 - Hybrid and Defined Benefit Plans
- State Police Officers' Retirement System (SPORS)
 - Defined Benefit Plan
- Virginia Law Officers' Retirement System (VaLORS)
 - Defined Benefit Plan
- Judicial Retirement System (JRS)
 - Hybrid and Defined Benefit Plans
- Optional Retirement Plan
 - Defined contribution plan for political appointees, school superintendents and faculty members at the state's public colleges and universities
- 457 Deferred Compensation Plan
 - Supplemental plan available to state employees

Sources: 2014 Virginia Retirement Systems Comprehensive Annual Financial Report, Commonwealth of Virginia 457 Deferred Compensation Plan

VRS Hybrid DC Component Investment Options

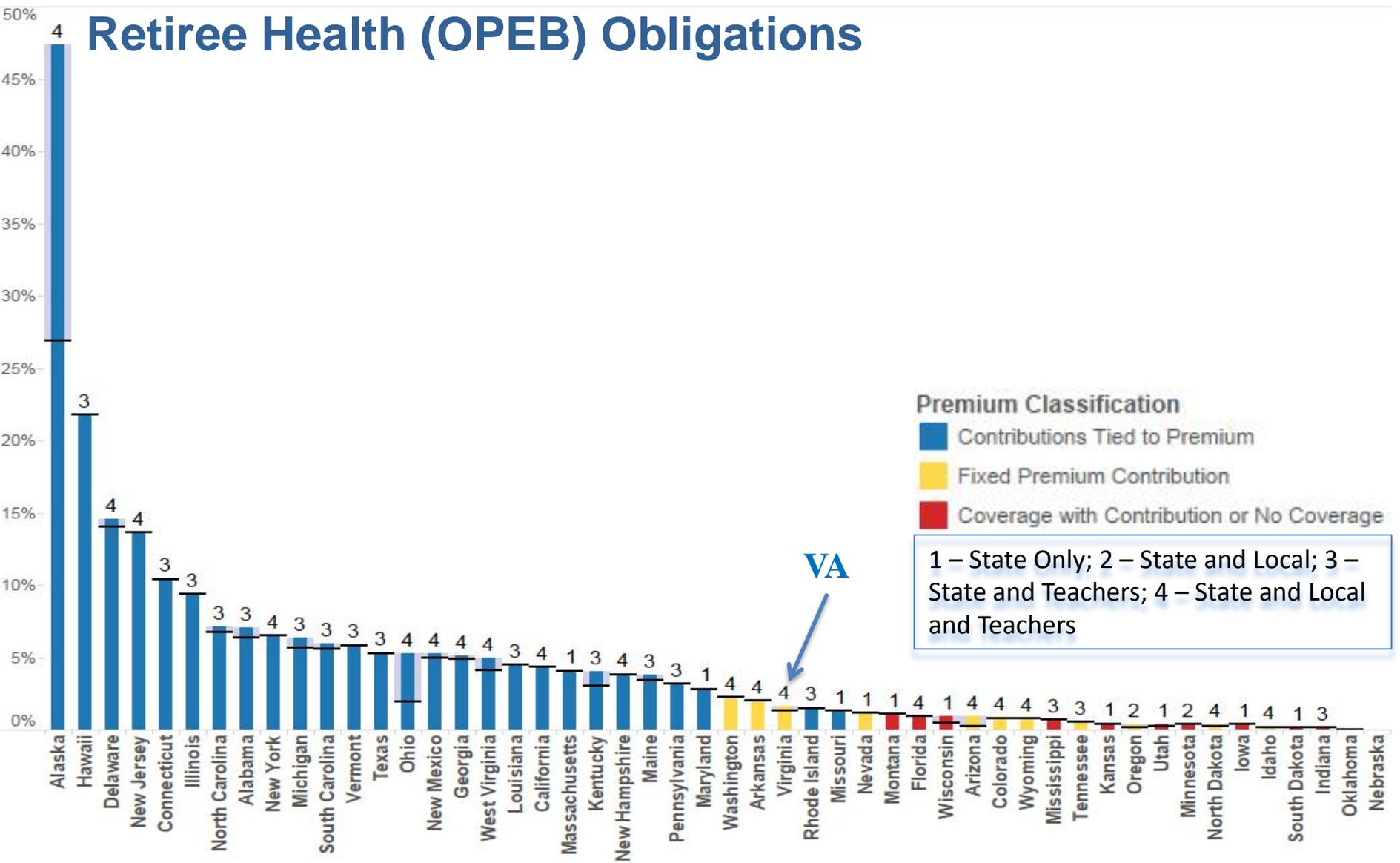
- Nine target date portfolios
- Eleven other fund options
 - Money Market
 - Stable Value
 - Bond
 - Inflation-Protected Bond
 - High-Yield Bond
 - Stock
 - Small/Mid-Cap Stock
 - International Stock
 - Emerging Markets Stock
 - Global Real Estate
 - Virginia Retirement System Investment Portfolio
- Self-directed brokerage account (SDBA)

Source: Virginia Retirement System

Well-designed DC

- Low-fee index and target date funds (Fed. TSP, Washington State)
- Investment manager selection process
- Auto-escalation on worker DC contributions
- Distribution options: safe rate withdrawal (default) and annuity accumulation
- Target benefit plan education
 - Accounts for social security, DB, DC
 - Active choice on distribution options at key ages

Retiree Health (OPEB) Obligations



Purple shading indicates plan assets; the bar represents total liabilities as a percentage of personal income.

Key Pension Terms

- **Liabilities** – Total value of pension benefits owed to current and retired employees or dependents based on past years of service; sometimes referred to as the Actuarial Accrued Liability (AAL).
- **Assets** – Money on hand to fund benefits. Assets build up over time, generally from three sources: employee contributions, employer contributions and investment returns. Some plans use actuarial smoothing to only acknowledge unexpected investment gains and losses over a period of time—usually five years. Those plans present an actuarial value of assets as opposed to a market value of assets.
- **Funded Ratio** – Assets divided by the actuarial accrued liabilities. Ideally, plans will be 100% funded or close to it.
- **Pension Debt** – Difference between the actuarial accrued liability and the actuarial value of plan assets on hand. This is the unfunded obligation for past service; sometimes referred to as the Unfunded Actuarial Accrued Liability (UAAL).
- **Actuarial Required Contribution (ARC)** – Amount of money actuaries calculate the employer needs to contribute during the current year to pay for retirement benefits. This is the sum of (1) “normal cost,” or the cost of benefits earned in the current year and (2) an additional catch-up payment on the unfunded actuarial accrued liability (UAAL) called the amortization payment.
- **Amortization Policy** – Rules for how actuaries calculate the amortization period when computing the ARC. Key parameters are how long the employer has to pay off the debt (often 30 years), when payments are level or backloaded (level dollar or level percent of payroll), and whether the amortization period shrinks each year or resets annually (closed versus open).
- **Assumed Rate of Return** – Estimated return on investments used by actuaries to project the actuarial value of assets and liabilities.

Plan Type Definitions

- **Defined Benefit Plan (DB):** traditional pension plan with a fixed monthly retirement income benefit based on age, years of service, and worker's salary.
- **Defined Contribution Plan (DC):** 401(k)-style plan with the retirement benefit based on accumulated employer and employee contributions, and returns on those investments.
- **Hybrid Plan:** plan that combines elements of DB and DC plans; "Side-by-Side" is the most common type of hybrid plan, where employees get a reduced DB benefit plus a DC account.
- **Cash Balance Plan (CB):** plan where benefit is based on employee and employer contributions that are pooled and professionally managed with a guaranteed minimum rate of return and annuitization option at retirement.

Lessons Learned from Successful Pension Task Forces

- Clear objectives and timeline
- Inclusive of stakeholder views
- Balance retirement security and fiscal sustainability
- Data-driven and transparent