National Institute on Retirement Security Research Report
"Lessons from Well-Funded Public Pensions: An Analysis of Six Plans that Weathered the Financial Storm"

Background

The National Institute on Retirement Security (NIRS) hosted a webinar on June 29, 2011 to announce the release of their research report, "Lessons from Well-Funded Public Pensions: An Analysis of Six Plans that Weathered the Financial Storm." The report was written by Dr. Jun Peng, an Associate Professor at the School of Government and Public Policy at the University of Arizona and Ilana Boivie, Director of Programs for NIRS. The webinar was hosted by Diane Oakley, Executive Director of NIRS with participation by Dr. Peng, Ilana Boivie, Tom Lee (Executive Director for New York STRS) and Ronnie Jung (Executive Director for Texas TRS).

Issue Summary

While the financial crisis lowered the funded levels of most public pension plans, several plans were able to maintain a well-funded status. For a number of plans that were not well-funded going into the financial crisis, the crisis further deteriorated their funded status. NIRS analyzed six well-funded public pension plans to learn what practices, in terms of funding policy, benefit design, and economic assumptions have resulted in a better financial condition for these plans. NIRS believes this provides a platform for further discussion on pension benefit reform in the public sector.

Methodology of Plans Selected

NIRS selected six plans to review based on the following criteria:

- Plan well-funded through the study period (2000-2009);
- Plan used actuarial method "entry age normal;"
- One plan per state.

Based this criteria, the following six plans were selected:

- Delaware State Employees' Pension Plan
- Idaho Public Employee Retirement Fund
- Illinois Municipal Retirement Fund
- New York State Teachers' Retirement System
- North Carolina Teachers & State Employees Retirement System
- Teacher Retirement System of Texas

Common Features

NIRS found that the following features helped the study plans remain well-funded over the long term (described in detail below):

- Employer pension contributions that pay the full amount of the actuarially required contribution (ARC), and that maintain stability in the contribution rate over time that is at least equal the normal cost;
- Employee contributions to help share in the cost of the plan;
- Benefit improvements, such as multiplier increases, that are actuarially valued before adoption and properly funded upon adoption;
- Cost of living adjustments (COLAs) that are granted responsibly;
- Anti-spiking measures that ensure actuarial integrity and transparency;
- Economic actuarial assumptions (including both the discount rate and inflation rate) that can reasonably be expected to be achieved long term.

NIRS also emphasized that this is not a “one size fits all” prescription, as each fund adopts various strategies based on its own specific situation.

Employer Contributions

Employer contributions have the dual goal of maintaining a well-funded level and having contribution stability.

- Paying the full ARC each year is the best way to stay well-funded.
- Paying at least the normal cost each year can lead to more stability in contribution rates.

Employee Contributions

Employee contributions help share the cost of pension benefits. Most employee rates are fixed.

To share cost volatility, the employee rate can be made variable.

- Idaho Public Employee Retirement Fund: Adjustable employee rate (an unusual scenario).
- An alternative option is for the employee rate to have two components: a set portion of the normal cost, plus an additional rate for potential cost volatility.

Benefit Design and Benefit Improvements

Benefit adequacy is often measured by the “replacement rate” (percentage of pre-retirement income replaced by all forms of post-retirement income).

- According to NIRS, most experts say the replacement rate should be 77-90 percent.
- This study only included plans which provide pension benefits that replace between 55 percent and 69 percent.
- According to NIRS it is prudent to actuarially value benefit improvements before adoption and properly fund them upon adoption.

COLAs

COLAs can maintain balance between inflation protection and affordability. For example, according to NIRS, 3% inflation can effectively “reduce” a $2,000 benefit at age 62 to a $993 benefit at age 85.

NIRS found that the best way to design COLAs is with prefunding and capping of automatic COLAs and with amortizing ad hoc COLAs quickly (5 – 9 years).

Anti-Spiking

Spiking is uncommon as most plans have at least a 3 year final average salary calculation. However, NIRS acknowledged that a high level of attention to individual spiking cases can create the impression of widespread abuse.

NIRS argues that spiking can be minimized in several ways:

- Final average salary that is used to determine pension benefits cannot include a one-time payment at the time of termination.
- Growth rate in total salary in the final years including overtime cannot exceed a certain calculated percentage (such as average salary growth for the entire government), or a preset percentage.
- Final average salary is capped.

Economic Assumptions

NIRS states that accurately assessing expected investment returns is important. It also states that a mismatch between the interest rate assumption and the actual interest earned will likely lead to a mismatch between the size of the plan's assets and its liabilities.

All six plans in the study had an "average rate of return" assumptions of somewhere between 7.25 percent and percent. As of 2009, each had a 25 year average return of over 9 percent.

Conclusion

The overall message is that in the current discussion on unfunded liabilities and pension reform, what is often missing is an understanding of the considerable variation in the financial health of public pension plans. While it is true that some state and local pension plans are not well-funded, and a few are severely underfunded, there are still many public pension plans that are consistently well-funded, even in the wake of the Great Recession. The existence of well-funded pension plans illustrates that public pensions can be designed to be affordable and sustainable, even during significant economic downturns.