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**Public Pensions and State & Local Budgets:
Can Contribution Rate Cyclicity Be Better Managed?**
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**THE FUTURE OF PUBLIC EMPLOYEE
RETIREMENT SYSTEMS
A WHARTON IMPACT CONFERENCE
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Rates on a Roller Coaster Ride

3



Rate Cyclicity

4

- ❑ **Effects on S&L Government Budgets:**
 - **Contribution Mechanics**
 - **Recent Rate Record**
- ❑ **Strategies to Stabilize Rates:**
 - **Asset Valuations**
 - **Liability Restraints**
 - **Direct Rate Controls**

Rate Mechanics

5

System Revenues

Investment Income

Contributions

- Employee (set by statute/agreement)
- Employer (Annual Required Contribution)

Rate Mechanics

6

- ❑ Annual Required Contribution (ARC):
 - Pension cost allocated to current fiscal year
 - Amortization of the Unfunded Liability

- ❑ Percent of ARC Made:
 - All, or None (or Partial)

ARC Variables

7

- ❑ **Benefit changes**
 - Increased benefit factor
 - Earlier retirement age
- ❑ **Actual experience compared to expectations**
 - Investment gains/losses
 - Membership behavior
 - Changes in assumptions

Contribution Rate Volatility

8

- ❑ From 1997 to 2002 employer rates fell from a high 10.5% of payroll to a low of 6.8%
- ❑ Five fiscal years ending in 2002 saw average decreases of 8.3% per annum
- ❑ Many funds experienced contribution holidays even though average rates were never below the 6.8% mark

Contribution Rate Volatility

9

- ❑ These rate trends track the increasing average funded ratios from about 85% in fiscal 1994 to more than 100% in 2000
- ❑ Funding was aided by the shift to higher equity allocations from 47% in 1994 to 61% in 2000
- ❑ S&P 500 Index grew at an annual average pace of 22% from fiscal 1995 to 2000

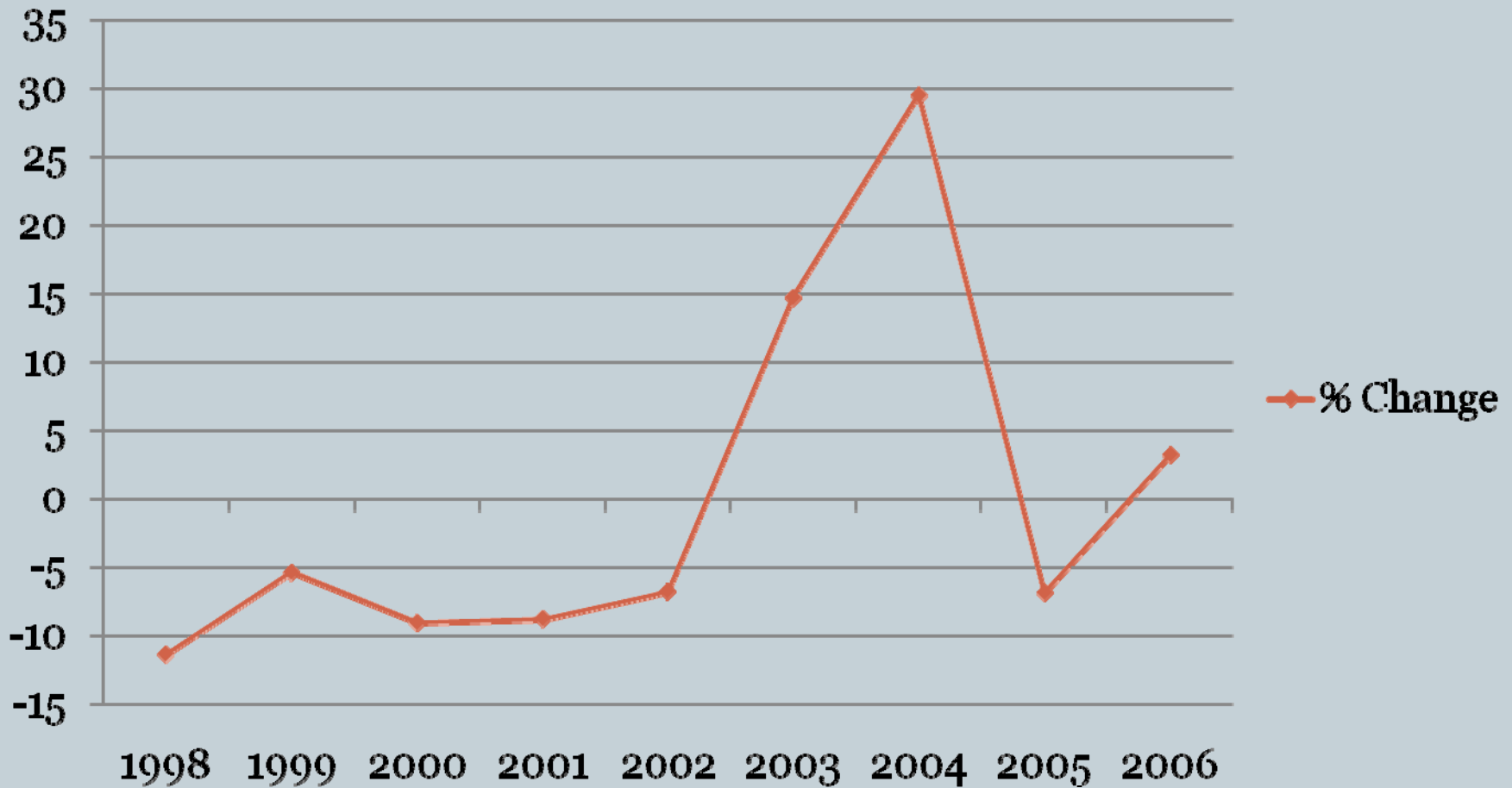
Contribution Rate Volatility

10

- ❑ Following S&P 500 declines of 16% in fiscal 2001 and 19% in 2002, employer rates increased 15% in 2003 and 30% in 2004
- ❑ Benefit increases and demographic changes also contributed to the funding declines and rate increases

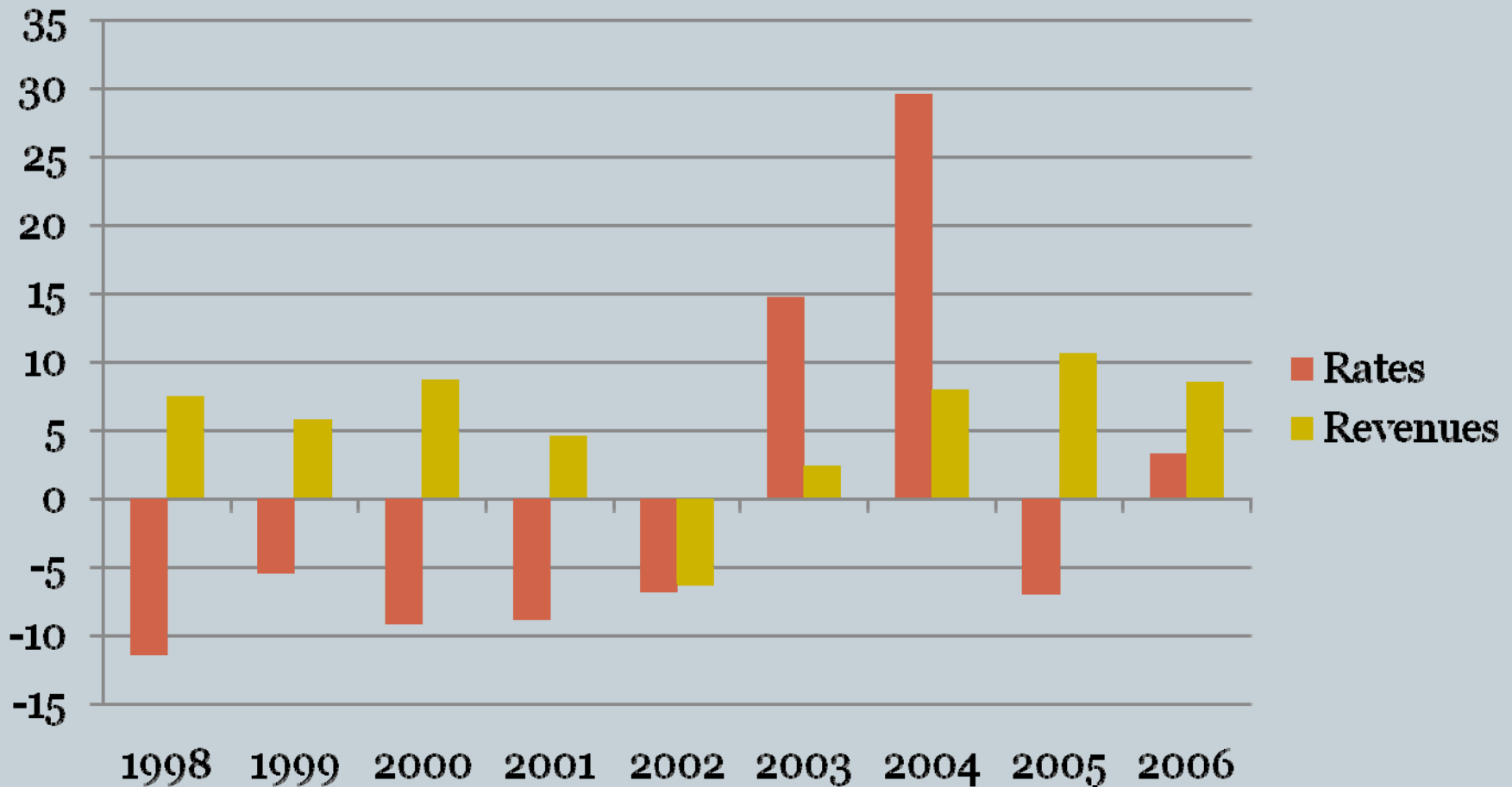
Employer Rates

11



Rate & State Revenue Trends (% Change)

12



Stabilization Strategies: Assets

13

- ❑ Most public funds use some kind of asset smoothing
- ❑ Gains/losses spread over 3-5 years
- ❑ Smoothing had been reasonably effective until the recent experience

CalPERS Rate Experience

14

Conducted a rate stabilization/asset smoothing study to find the best method which:

- ❑ Minimizes any negative impact on the funded status of the plans
- ❑ Minimizes the volatility of the employer's contribution
- ❑ Minimizes the average future employer contribution

CalPERS Rate Study Results

15

In April 2005, the Board adopted new policies including:

- ❑ Spreading asset gains/losses over 15 years (prior policy: 3 years)
- ❑ Increase actuarial value of assets corridor to 80%-120% of market (90%-110%)

CalPERS Rate Study

16

www.calpers.ca.gov/eip-docs/employer/actuarial-gasb/rate-stabilization-4-05.pdf

CalPERS Update

17

- ❑ About 75% of local public agency plans had employer rate changes of less than 1% between fiscals 2006 & 2007
- ❑ Remaining 25% included plans that increased benefits and had a planned change in employer rate

Stabilization Strategies: Liabilities

18

- ❑ Any benefit enhancement increases liabilities and the Normal Cost Contribution
- ❑ There is not always a good rationale for a benefit increase
- ❑ Funding of the future increased contribution costs is usually not planned
- ❑ “Over-funding” fallacy

Liability Restraints: Examples

19

- ❑ Georgia: Constitution requires ‘actuarial soundness’
- ❑ Minimum period between introduction and enactment of pension bill changes of 1 year
- ❑ Actuarial investigation must be performed

Liability Restraints: Examples

20

- ❑ **San Francisco: benefit changes must be approved by voters**
- ❑ **Taxpayers decide if they are willing to pay the increased costs for higher benefits**

Stabilization Strategies: Direct Controls

21

Rate Floors

- ❑ New York State mandated minimum contributions of 4.5% of payroll in May 2003
- ❑ If law had been effective in 1998, an estimated additional \$4.8 Bil. would have been collected and rates would have been about 2% lower in fiscal 2004

Stabilization Strategies: Direct Controls

22

Fixed Rates

- ❑ Fixing rates solves contribution volatility issue...but may exacerbate others
- ❑ If actuarial losses are severe, funding can suffer
- ❑ If contributions cannot be increased, how can system balance be attained?

Fixed Rate Example: CalSTRS

23

California State Teachers Retirement System Statutory Contribution Rates

- ❑ **Members=6% of earnings**
- ❑ **Employers=8.25% of earnings**

CalSTRS

24

- ❑ Reported an Unfunded Actuarial Obligation of \$20.3 Bil. as of June 30, 2005 in Defined Benefit Program
- ❑ UAO did not amortize over any time period
- ❑ To reach full funding needed equivalent of increase of 3.753% of salaries over 30 years
- ❑ Looking at a number of options

Conclusions

25

- ❑ Pension rates are real cost pressure for employers
- ❑ Recent rate volatility has been a serious issue for many employers
- ❑ Some have acted to reduce future swings
- ❑ Strategies include longer smoothing periods, minimum contribution rates--plus other solutions are being studied

Conclusions...continued

26

- ❑ Rate volatility may be part of the price of riskier asset allocations
- ❑ Solutions are not one size fits all
- ❑ Individual fund remedies depend on its unique plan features & other variables (political?)
- ❑ Corrective action may include a combination of strategies affecting both assets & liabilities