# The Future of Public Employee Retirement Systems
# Wharton Impact Conference

## Pension Research Council
## Boettner Center for Pensions and Retirement Research

**Reform Paths for Public Plan**

Discussant Comments

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**William B. Fornia, FSA**

# Reform Paths for Public Plans
# Discussant Comments

- Defined Contribution (DC) Plans in Public Sector – Best Practice Benchmark
  - Brief Comments
- Improving Cost Effectiveness of Defined Benefit (DB) Retirement Plans
  - General Comments
- Improving Cost Effectiveness of DB Retirement Plans
  - In defense of the "faulty measuring stick"

# DC Plans in Public Sector – Best Practice Benchmark – Brief Comments

- Strong emphasis on annuitization – This helps solve major weakness of DC plans
- Good comprehensive “Principles for Effective Core DC Plans”
- Valuable summary of major public DC plans

# Improving Cost Effectiveness of DB Retirement Plans – General Comments

- Thorough treatise in support of using "full liability-matching asset portfolio" to meet goal of minimizing contribution volatility and liability volatility
  - for a plan which bases contributions and liability on "market value" liabilities (MVL)
- This approach has value for private sector pension plans
- But this approach undermines public sector pensions

# Improving Cost Effectiveness of DB Retirement Plans – Defense of the "faulty measuring stick"

- There are numerous papers supporting a move to reporting of MVL, but these are generally:
  - Focused on corporate pensions, and
  - Rebutted by most public pension actuaries for public pensions
- MVL proponents have the advantage of well-chosen words: Which seems more credible?
  - Actuarial Liability, or
  - Market Value Liability

# Between *Scylla* and *Charybdis*

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- ***Scylla*** characterized as ***legislature terminating plan***
- ***Charybdis*** characterized as: ***"the underfunding problem will progressively get worse until the plan falls over of its own weight"***
- Weak evidence that Charybdis will occur
  - "Progressively worse underfunding" can be avoided by funding actuarial contribution based on "faulty measuring stick"
- Absent panic, Scylla has been successfully avoided

# Between *Scylla* and *Charybdis*

- ***Scylla*** for businesses, is ***plan termination***
- ***Charybdis*** for businesses, is ***an earnings surprise or potential reporting of a minimum liability on balance sheet***
  - Financial Accounting Standard 87 (and PPA) require costs/contributions be based on "discount rate" tied to bond rates
  - Volatile and high pension costs can reduce EPS and put strain on stock price
  - Businesses also have bankruptcy risk, where MVL is a relevant calculation

# Between *Scylla* and *Charybdis*

- This monster and destructive force need not torment the public sector
- Why not?
    1. *Bankruptcy likelihood is extremely low*
    2. *Plans don't terminate under ERISA rules*
    3. *Governments' purpose is not to maximize shareholder value, but to provide services*
    4. *There is no market for governments and government pensions*
- Public pensions not required to utilize "market value" liabilities

# More appropriate Greek mythological analogies

- Pandora's Box
- Trojan Horse
- Nemesis

# Pandora's Box

# Reporting MVL could open Pandora's Box

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IX. Individuals also shift from equities to bonds

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VIII. Push to Defined Contribution (DC) plans
IX. Individuals also shift from equities to bonds
X. Equities continue to drop in downward spiral

# Trojan Horse

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- What seems like a more effective approach to funding public Defined Benefit plans is only more effective if public plans are required to report costs and liabilities using bond rates
- If we continue on the "faulty" measuring stick, public plans can invest in equities and reap the reward of the higher returns, saving taxpayers money in the long run

# Nemesis

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- Nemesis is related to other concepts:
  - Liability driven investing
  - Financial economics (the pension subset)
  - "Economic" cost or value
  - "True" cost or value
  - "Transparency"
  - "Mark to Market"
  - "Moral Hazard"

# There are weaknesses in the current approach, but they are not cured by "market value" liabilities

- Current "faulty" approach if used alone does not reflect risk of not earning actuarial expected return
- This can lead to incomplete understanding of:
  - Surplus or Unfunded Liability
  - Cost of improving benefits
  - Strategic "bets" such as Pension Obligation Bonds

# Instead of "market value" liabilities, utilize other approaches

- Look at actual values using multiple rates of investment return
  - This could include bond rates
- Stress tests
- Sensitivity analysis
- Stochastic simulation
- Risk of ruin
- Forecast actuarial values using alternate rates of investment returns
- Asset-Liability forecasts
- What-if scenarios based on key plan objectives

# Questions? Comments?

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**William Fornia**
**Senior Vice President**
**303.782.3394**
**William_Fornia@aon.com**