

Public Pension Plan Design for the Future: A Perspective

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This paper has been prepared as an expansion of my views on future plan design and high-level policy issues for public pension plans to be presented at the conference. The focus of this sub-session is — *“Decisions about the future of pension plans to ensure sufficient retirement security for public sector workers and sustainable fiscal responsibility for state and local governments: What elements are essential to preserve? Necessary to drop? Important to add? Why?”*

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Public Pension Plan Design for the Future:

A Perspective

If public pension plans are to be both financially sustainable and relevant into the future, they must provide (1) reasonable retirement security for employees and (2) funding mechanisms that meet the needs of state and local governments.

Retirement Security

The primary purpose of a public pension plan is to provide an adequate level of retirement security for a specific group of public employees. Adequate retirement security must include (1) protection from individual risks that can be effectively managed in larger groups; (2) protection from loss of all benefits already earned (even if not payable until some future time); (3) the ability to port or retain benefits when changing jobs without suffering a loss of benefits, including future investment returns; (4) a greater individual flexibility and options to tailor retirement related decisions to individual needs and desires; and (5) the means and opportunity to deal effectively with the impact of post-retirement inflation to support a continuation of the standard of living experienced in the early years of retirement.

Pooling to Protect Against Individual Risks. As individuals there are a number of risks that we have no control over. The most notable of these is how long we will live. One important result of this uncertainty is that we cannot effectively plan how to best utilize our resources during retirement. This results in a high probability that an individual will either run out of resources before death or suffer a lower than necessary standard of living while alive. However, by pooling the experience of a large group of individuals and providing annuities based on the average life expectancy, an individual can be guaranteed benefits for the remainder of his or her life.

Public pension plans provide this benefit assurance through annuities at very little or no cost to the employer. The retiree also receives a significantly greater benefit as compared to ones available to individuals through a private insurance company. For example, a retirement benefit¹ based on an immediate payment of \$100,000 under a public plan would be \$700.00² as compared to a private annuity of \$546.25³ — a 28% greater benefit. From another perspective, \$500,000 would purchase an annual annuity of \$42,000 under the public plan, but the same annuity would require \$640,732 through a private source. This is a major factor in maximizing the value of benefits for a given cost.

¹ monthly joint and 100% survivor annuity for male retiree and female beneficiary, both age 65.

² based on current annuity purchase rates of the Texas County & District Retirement System.

³ based on 10-10-2005 quote through vanguard.com based on rates established by AIG Life Insurance Company and American National Life Assurance Company of New York.

Another area of risk where individuals can be disadvantaged is in the investment of assets. The source of such risk can be traced to some combination of (1) the need for asset liquidity versus market volatility, (2) a lack of access to low fees and expenses, and (3) access to adequate investment knowledge and opportunities.

Capital markets are highly volatile during shorter timeframes. However, over longer timeframes the returns tend to regress to the mean. Pooling of assets for investment purposes within a public pension plan allows a long-term investment perspective which provides opportunities for maximizing returns and reducing risks. A public pension plan includes individuals with a wide range of characteristics. Some are drawing out resources to pay for retirement needs and others are in various stages of the accumulation process in preparation for a future retirement. Some have a very short-term investment horizon; some have a very long horizon; and others fall somewhere in between. This, plus the fact that employers generally have a long-term horizon, allows the pension plan to invest all assets with a long-term perspective and at the same time provide short-term return guarantees for retirees and those close to retirement.

One financial characteristic associated with retirement is the need for liquidity. Retirees have more or less fixed expenses that occur month to month. In many economic environments, this need is unlikely to be met from dividends and interest produced by investment portfolios which have been positioned to provide higher total returns over time. This leaves a retiree with two choices: (1) give up potentially higher total returns by investing in assets paying higher current income, or (2) liquidate a portion of the portfolio each month to offset the shortfall in current income. In either case, the net result to the retiree is a reduced overall return.

As individuals, retirees are charged much higher fees and expenses than those paid by a pension plan. Through pooling of funds, public pension plans incur investment costs that are a small fraction of those that you or I would be subject to as individuals. As large investors, public plans also have access to the best and brightest money managers, advisors and other consultants. Individuals seldom have such access — in fact, we usually find ourselves in the backwater of the investment world. This investment world for ordinary individuals is usually a place where we must either stand alone or rely heavily on an advisor that we don't really know that well.

In addition to managing these two very important individual risks, public plans traditionally have also provided the advantages of pooling in other areas. In some cases these have been subsidized by the plan and in others the benefit of pooling has been provided at cost. Such non-retirement — but very important — opportunities for pooling of experience include disability prior to retirement, survivor benefits, and long-term care benefits.

Guarantees for Earned Benefits. Benefits attributable to service already rendered should receive unqualified guarantees. This may require the underwriting of this promise by the pension plan or, in the case of a single employer plan, through an insurance contract provided by the employer or some other form of umbrella protection. In either

case, each employee must be confident that his or her benefits will be there when needed — regardless of how far away retirement may be. On the other hand, the same level of assurance for benefits attributable to future service cannot be expected.

Such guarantees require a clear and understandable definition of what constitutes an earned benefit and the traditional actuarial present value calculation of some assumed future benefit using an assumed discount rate may not be appropriate. This definition must quantify the value of the benefit at the present time but not necessarily include any presumptions for the future. The value of earned benefits should also not be frozen at the point of employment termination; rather, a fair share of future investment return should enhance the future benefit values and the employee should be subject to appropriate changes in mortality rates and other demographic and economic results.

Additionally, the value of benefits already earned should be protected — by priority funding or other means — from the dilution of funding as a result of future benefit increases, future failures to adequately fund, etc. Here again, it is not the ultimate monthly benefit that should be protected, but the appropriate value as of each current point in time.

Benefit Protection through Portability. During the 1930's through the 1950's, the basic plan design of most public pension plans was cast. During this period, the employee–employer relationships were very different from those that exist today. There were also major differences in careers, expectations, demographics, attitudes, and culture. Long careers with a single employer are far less common today. While some worked for more than one employer, this typically occurred very early in a person's career. Consequently, the work period with the final employer usually covered the major portion of a person's working life and incorporated the period of his or her greatest productivity and highest compensation.

Long-service employees were highly valued and the retirement benefits were designed to encourage and reward this. Quite often, higher retirement benefits were promised in lieu of current salary — often due to budget or other political considerations. All of these were in tune with the needs, desires, and conditions of the time — but things gradually began to change.

Two-income families replaced single-income ones as the most common. Employees began to have fewer opportunities for or became less content with spending an entire career with a single employer. The roles and services provided by public employers began to change, resulting in changing needs for employees with particular skill sets. The need for some skills grew or increased in importance while some declined and others ceased to exist altogether. Public employers can no longer reasonably promise employees that a job will exist throughout a working career. Public employers also began to compete more directly with the private sector for the same employee skills. Rapid growth of technology and other external pressures have accelerated this process. Careers became less linear. Mid-career and late-career changes became much more common — often punctuated with periods of re-education. The needs, desires and priorities of the

generations born following the great depression era are very different than those that were so heavily influenced by that event.

This will increasingly call into question the features of defined benefit plans which disproportionately favor one employee over another, such as rewarding long service employees over those with shorter service. The primary reason for this is that the makeup and attitudes of the employee groups is continuing to evolve. For example, there are fewer career employees, and more of the shorter service employees are concerned about their benefits when they terminate.

The magnitude of this change is illustrated by a recent report from the Bureau of Labor Statistics. This report indicates that baby boomers born from 1957 to 1964 held an average of 10.2 jobs between the ages of 18 and 38.⁴ As a result of this gradual but dramatic change, there has been increasing pressure to shorten the periods of employment necessary to receive a retirement benefit or a right to a future benefit so that benefits would not be lost when a person moved from one employer to another or arrived at their final employer late in their working career. Increasingly, the benefits earned at the final employer have become inadequate to provide a continuation of the standard of living into retirement. This, in turn, increased pressure to raise benefit levels — to excessive levels in some cases. Each such change increased the ultimate costs of benefits, but fell increasingly short of meeting the real need — portability of retirement benefits.

It is important to ensure that each individual has the opportunity to preserve the benefits earned from all employers and that each employer provide a fair and equitable portion of a full retirement benefit. To accomplish this, it is necessary to improve the portability of benefits — either directly or indirectly. Direct portability may not be feasible in most cases due to the vast differences in public plan design and the corresponding difficulties associated with accurately valuing the liability in order to make an appropriate transfer of assets. Additionally, significant problems can arise when employer assets are moved from plan to plan and where one plan is charged with the administration and payment of benefits earned at another. It is, however, possible to provide indirect portability through two plan features. The first is to provide a vested right to a proportionate benefit at the normal retirement age after a very minimal period of service — ideally no more than one or two years. The second feature is to ensure that the benefits are increased after termination of employment by continued participation in the investment return and in the mortality gains resulting from any delay in actual retirement beyond the normal retirement age.

Reward Individuals Who Postpone Retirement. The expectation of many individuals — to work 30 years, retire by age 60 and then enjoy a life of leisure for an additional 30 years — is not realistic. To accomplish this, each individual or couple, on average, must be sufficiently productive during their working careers to not only meet their needs and those of their family during that period but also be sufficiently productive to

⁴ Wiatrowski, William J., “Retirement Plan Design and the Mobile Workforce” (U. S. Department of Labor, Bureau of Labor Statistics, Compensation and Working Conditions Online, September 28, 2005), <http://www.bls.gov/opub/cwc/>.

simultaneously accumulate (within pension plans, in Social Security credits, and through individual savings) the millions of dollars necessary to meet their needs during retirement. Or in other words, expect to work and produce for 30 years and consume for 60 — or more.

In thinking about and planning for retirement, most of us tend to forget that life expectancy estimates do not represent a likely maximum age for any individual. Instead it is the age that half are expected to live beyond — many well beyond. Presently, it is almost as likely as not that at least one member of a couple reaching age 65 will still be alive after 25 years. In almost one of five cases, one spouse will live beyond age 95.

For the majority of us, the economics just doesn't work — we either have to work longer, save more while we are working by accepting a lower standard of living, continue to work after retirement, sharply reduce our retirement standard of living, or some combination of these. It is also reasonable to expect that the future will only produce additional challenges through increased life expectancies.

Many plan design features now serve as disincentives to a person continuing to work after reaching some arbitrary “normal” retirement age. This is often a disservice to the employee, employer and society alike. The employee is encouraged to begin consuming retirement savings earlier — most likely to his or her long-term detriment or that of his or her family. The employer loses a valuable employee and important organizational knowledge — while at the same time, incurring increased recruitment and training costs. Society has a potentially productive member kicking back and consuming retirement savings prematurely — increasing the likelihood that he or she will become a future burden on family and society. Even if the person continues to work in another job, his or her productivity is likely reduced — a net loss to society and additional burdens on future generations. Therefore, to better serve the interests of all, public employees must be encouraged — through plan design features, communication, working environments, and public attitudes — to work as long as possible. It is far more economically feasible to work 40 or 45 years and have periods of retirement in the 15 to 20 year range.

In order to encourage individuals to delay retirement, there must be both economic and emotional incentives. One such incentive is to insure that a person's benefits continue to increase appropriately beyond any arbitrary “normal” retirement date — even if the individual is not currently employed. These increases should fairly compensate the individual for both a share of the investment returns and the shorter period within which an annuity will be paid. Other incentives should include elimination of any arbitrary benefit maximum.

Frequently, individual decisions to retire are made as an emotional reaction to burnout or other job pressures rather than as a result of a well thought out retirement plan. In other cases, decisions are based on a need or desire for a reduced workload or time to devote to other interests. Phased retirement and short-term sabbaticals can be very effective in meeting the needs of the employees and preserving the employer's access to valuable experience and knowledge without significant increases in benefit costs. Phased

retirement should only be available at or near the “normal” retirement age. The funding source for phased retirement would be the individual’s retirement reserves. Phased retirement can also be an effect component of succession plans designed to ensure that organizational knowledge is transferred rather than lost.

Infrequent (every five or so years) sabbaticals have proven to be valuable tools for reenergizing and maximizing the careers of key long-term employees. There seems to be sufficient merit to warrant its consideration as an ancillary benefit within the public arena. However, such benefits should be available only after a person nears retirement age and a minimum amount of service has been completed with the current employer. They can be funded from vacation time, retirement reserves or some combination of these.

From time to time, there have been attempts to achieve non-retirement related human resources goals by making temporary or permanent changes to the pension plan design. One of the most common of these is workforce reduction efforts through incentives to retire early. These efforts nearly always fail because of the inability to predict in advance the decisions of individuals. Even though such practices may seem politically appealing, the use of the pension plan in this way will most likely increase costs far beyond the value of any gains made. Such practices should be discouraged or eliminated.

Retirement needs, desires and priorities are as diverse as people are. There is no one size that fits all. Yet, there has been a tendency to try to protect individuals from themselves by making decisions for them and taking away options. By preventing persons from making poor decisions by taking away options or assuming that each person’s needs are similar, we often unwittingly create even more dire and inappropriate outcomes. For many reasons, the best results are produced when each individual has the opportunity to tailor retirement plans from a wide range of options on the basis of his or her individual criteria with plan support through the decision-making process. Each of us is at risk for making a poor decision, but given sufficient information we will each do better than someone else’s preconceived notion.

Protection Against Post-retirement Inflation. The effect of even modest inflation on the purchasing power of a fixed annuity can be devastating. Likewise, even the fear of inflation and the uncertainty surrounding life expectancy can often produce irrational behavior. A strategy for post retirement inflation must become a part of the pension plan design and education program. Each individual considering retirement must be able to gauge what the impact of inflation might be and be provided options and tools to assist in mitigating the risk.

Because of uncertainty, it is difficult for employers to promise future cost of living increases. In fact, it is unlikely that any employer can fully bear such risks. The on-again, off-again nature of ad hoc increases are beneficial in maintaining the retiree’s purchasing power, but they may also serve to discourage individuals from developing a strategy on their own. Therefore, a solution where the risks are shared by both the employer and the employee may be the most beneficial and sustainable. From the employer perspective

there must be limits on such risks. The individual employee must then be able evaluate their situation and select from such options as: (1) reduced initial annuity with periodic increases, (2) continued savings after retirement to provide additional funds later, and (3) and acceptance of the risks and the need to reduce future expenditures.

Funding Sustainability

To remain viable, public pension plans must consistently maintain a financial status that is politically defensible regardless of the demographic and economic challenges that currently exist or that may occur at any time in the future.

Most public entities depend on tax and fee based revenues and operate within short-term budget cycles of one or two years. Therefore, the characteristics of the required pension plan funding are extremely important. Not only must the required annual contribution be reasonable in the mind of the public, but it must be relatively consistent from year to year as a percent of covered salaries. Therefore, funding of public plans must avoid any significant contribution rate volatility and must not fall prey to undetected economic or demographic trends that result in gradually increasing rates over long periods.

Accomplishing this requires reasonably accurate economic and demographic projections for future periods. Success is also highly dependent upon the actuarial methods employed and the ability of the plan to make temporary adjustments when major economic events occur or when the need for a significant change in an important actuarial assumption is detected.

It appears to me that public pension plans are being simultaneously squeezed from at least three different perspectives. The first is the increasing difficulty in absorbing or smoothing the effects of what are expected to be short-term market losses without risking even greater problems if the recovery proves to be delayed or insufficient. The second is the changing needs of the employees of today and tomorrow that are not being adequately met by current plan designs. And the third is the attitude of the public (through their elected officials) regarding what level of benefits and protection from risks is appropriate for public employees and what level of costs is acceptable — particularly in view of the pension plan trends within the private sector and in light of the significant increases being experienced in the cost of providing employee healthcare coverage.

From a review of some of the more recent meltdowns of a few public pension plans and from my own personal experiences, it seems likely that such meltdowns result from a series of adverse events and/or poor decisions evolving over time rather than as a result of a single recent major event. In most cases, a significant event (the most recent example being the market experience of 2000–2002) is likely the tipping point which precipitates the unraveling of the accumulation of other pressures and decisions. None of the recent cases appear to be the result of the market experience alone. Adverse events and poor decisions have existed from the beginning; however, in the past, plans had a greater ability to respond through such means as an adjustment to an actuarial assumption,

change to the income allocation policy or to weather storm by simply outgrowing the problem with a very high positive cash flow rate. As options have been exhausted by responses to past issues and as plans have matured, the expectations for the future were raised and growth rates declined to the point where few of these opportunities still exist for plans today — thereby increasing the risks.

Therefore, I believe that the greatest risk facing the public pension industry is the gradual accumulation of external pressures, poor decisions, and lost opportunities to change from plan to plan. I don't expect a sudden collapse, but rather a continuation of what has already started — one plan after another reaching some tipping point and resulting in knee-jerk reactions in the political arena. It is likely that the “solution” will often be to close the plan to new employees — sentencing the plan to a slow death by strangulation. As one governmental entity after another manages to effectively shut down its defined benefit plans, it will encourage others. Those plans that ignore the need for change or who are thwarted by the political process will continue to lose opportunities to provide sustainable funding and eventually reach their tipping point.

An important financial opportunity for public pension plans is the leveraging of the advantages of size in such areas as (1) reduction of costs and (2) enhanced investment opportunities. But more importantly, public plans need to continue to proactively embrace change and develop new opportunities to replace those that have been lost through past efforts to reconcile the short-term perspective of the plan owners (employers, public, and public officials) with the requirement that public plans maintain a long-term perspective matching the long-term nature of the financial promises to the plan beneficiaries (i.e., employees, retirees, survivors).

The Advantages of Size. Larger pension plans have more opportunities to take advantage of economies of scale than do smaller plans and individuals. The size required varies from area to area; however, significant economies can often be realized in such areas as investment advisory fees and asset management fees. By pooling of assets (from different employers, plans and even separate trusts) for investment purposes, the asset allocation process is more efficient and easier to manage, change and maintain over time. A larger pool of assets tends to also reduce cash flow issues, provide better and cheaper access to high-quality advisors and money managers, and leverage internal staffing resources. Monitoring of investment advisors and money managers is an important fiduciary responsibility of boards of trustees. This is a more manageable process when the number of experts can be reduced through consolidation.

Overall administrative expenses can generally be lowered through reduced unit costs and improve opportunities for outsourcing of routine tasks at highly competitive costs. Utilizing economies of scale to reduce unit costs covers almost every area of plan administration.

Economies of scale can also provide modest assistance in stabilizing funding volatility through a larger group of individuals which is more likely to match expected

demographic experience than a smaller group might. For example, a large group of annuitants are more likely to match the expected longevity experience than a small group. This reduces the risk that the plan (and ultimately the employer) will suffer an unexpected actuarial loss and corresponding increase in liabilities.

Reconcile Short vs. Long-term Financial Perspectives. Successful management of the impact of an ever-changing demographic and economic environment in the face of long-term financial commitments is one of the greatest public pension fund challenges.

Unfortunately, there is no universal solution. And a solution for today may not solve tomorrow's problems. Ultimately, the key is flexibility — the flexibility to change and morph the plan design (including the benefit structure) and to develop new strategies as new needs unfold and new challenges arise.

Maintaining funding consistency in the face of long-term uncertainty is difficult, and a positive outcome is never guaranteed. However, better results can frequently be achieved by identifying and implementing ways that enhance the reconciliation of the short-term financial perspectives of the employers with the long-term nature of the benefit obligation. To do this, the characteristics of both perspectives must be well understood and the ability to pre-test theories prior to implementation must exist. This reconciliation of perspectives must be primarily achieved by providing flexibility in the basic plan design that can be utilized real-time to manage expected risks and smooth volatility. Because dealing with uncertainty is such a big factor in maintaining sustainable funding over long periods, the plan must provide employers with opportunities to partner in the risk mitigation process and allow the rebalancing of the benefit–funding equation when necessary.

The fiscal nature of public entities is essentially hand-to-mouth existence. Tax and fee revenues are collected — generally for the period of one year. Through an annual or biennial budget process (often highly politicized), the expected revenues are allocated to provide the necessary and desired services. There are seldom enough resources to satisfy requests. Therefore, when an expense that has been perceived as fixed — such as retirement contributions — is sharply increased, unexpected and significant pressure is added to an already contentious budget process.

On the other hand, sharp decreases in employer contribution requirements result in unexpected “free” funds that are quickly allocated to other budget areas — frequently areas of ongoing need. This new lower funding level immediately becomes the new norm and any increases in subsequent years fall in the “unexpected expense” rather than the “regular fixed expense” category. Consequently, the least amount of political pain will result, overall funding will generally be maximized, and existing benefits will most likely be unchallenged when the employer contribution rates can be maintained relatively smooth over time.

From the perspective of the pension plan, long-term obligations to employees are created and increased daily. But these obligations have no definite timeframe over which they become due and have a value that will not be finally determined until some largely

unknown future point. Furthermore, there is little or no real control over the decisions that will finally resolve this uncertainty. However, these obligations must be advanced funded during the working life of the respective employee. A major portion of the funding will result from investment return rather than contributions, but the investment results that will be achieved are not known. There is also no way to determine what other demographic, economic and cultural change will occur in the meantime.

Therefore, any calculation of the financial obligations requires a large number of assumptions — some to describe various demographics and others to define the economic future. If the assumptions are all correct, a long-term obligation can be calculated, and by having correctly guessed what the investment returns will be, this can be converted into a present value. The pension plan then needs only to let the future unfold and allow events to fall into place.

Unfortunately, none of the assumptions will be accurate. If we are lucky, the financial result will tend to average out over time, but the probability for even that is far less than winning the lottery. Actuarial science has, however, provided us with a strategy to accomplish the primary goal of determining how much should be contributed by the employers to fund the estimated obligation during the employee's working career. This calculation is made and governs the contributions for a year or two and then the process is repeated to take into consideration changes that have occurred, any recent funding overages or shortages, and any changes to be made in the assumptions. Each new contribution rate will be more or less, as a percent of pay, than the previous one — reflecting the combined impact of the change.

Generally, this rate setting process works well and normally produces annual rate changes that are within the short-term budget tolerance of employers. Problems arise, however, when sudden and significant rate changes occur. Problems can also arise over longer periods of time if modest rate increases become a longer trend. Early detection of such trends is very difficult, but such possibilities should be contemplated and addressed in the plan's design, benefit structure, and strategies. Failure to do so can result in increased funding risks, particularly when coupled with other dramatic cyclical change, such as a sharp downturn in capital markets.

One common source of significant and sudden change is an increase in benefits — particularly those that impact the benefits attributable to both prior and future periods. Another is the realization that an important assumption must be restated in order to more accurately reflect future expectations. For example, a reduction in the assumed rate of investment return impacts the discounting of required future benefit payments to their present value and can dramatically increase the unfunded obligation and the employer's required contribution.

An example of a slowly evolving trend is the steady decrease in employee turnover rates year after year. The effect on the employer rates would be minimal in the early years of the trend because it would likely be viewed as an aberration and not yet fully recognized in the actuarial assumptions. If later on when it became evident that the rate might not

return to expected levels, but actually might continue to decline, it would become necessary to strengthen the assumptions. This change in assumptions could result in major upward pressure on employer rates.

If the employers are asked to just deal with rate volatility or significant increases as best they can, it is likely that sooner or later they will either be forced to or elect to take more drastic action. This might result in a decrease in future benefits (provided that is an option) or the abandonment of the plan altogether. Based on my experience, employers will go to great efforts to avoid cutting benefits and even then, the cuts may only be temporary. However, when pushed to the edge, employers have terminated plans and, in extreme cases, abandoned their obligations through privatization.

The problem becomes even more difficult when both the short-term financial goals of the employers and the long-term retirement goals of the employees change — and the faster the change, the greater the difficulty.

Embrace and Prepare for Change. In the final analysis, the most critical element is for all stakeholders to embrace change and spend available resources preparing for it rather than trying to resist. Resisting change simply places the pension plan farther away from reality and reduces its ability to respond to real employee and retiree needs, or increases the likelihood of the plan being adversely affected by future events. Adverse events usually impact all stakeholders. The most successful plans going forward will be those that recognize change sooner, are better at identifying and testing strategies, and that avoid becoming complacent.

A key ingredient in any long-term decision-making process involving significant uncertainty is information — projections that provide insight into likely results under a wide range of possible futures. The best and most flexible plan design will not achieve the desired goals unless also combined with the constant review of the plan's policies and strategies driven by effective financial modeling and other fact-based projections. Likewise, the employers and employees cannot make good current decisions without also knowing what the longer-term consequences might be.

Features Which Can Enhance Funding Sustainability

Through enhanced funding stability, opportunities for meeting the current and future retirement needs for employees will also be enhanced. If the employer budgeting process is not stressed by the pension plan funding requirements, there is a high probability that the level of funding required and the level of benefits provided will not become a negative issue with the employer or the public. Likewise, if there is a track record of relatively low rate volatility, the employer is more likely to increase benefits when the opportunity and need arises. This is important from the employee perspective, not only in terms of benefit dollars, but also the increased assurance that their future expectations are likely to be met. Therefore, to bridge the gap between the short and long-term perspective and in turn better serve all stakeholders, it is important that the pension plan itself

produce rate results as consistent with the employers' needs as possible, while also being responsive to the change in employee needs.

Accomplishing this is a journey rather than a solution. It is necessary to analyze every part of the plan and understand what might cause future funding surprises, identify ways of smoothing the results and incorporating the necessary change, and then doing it all over again. Good results will most likely be produced from many small modifications rather than a few more significant ones. Likewise, changes in direction are usually slow to provide highly visible results, making the early detection of new trends and change even more important. There is no magic — no universal solution.

Some of the plan features and techniques that I have seen employed and that help lower rates and rate volatility are (1) consolidation of smaller, single-employer plans into multiple-employer plans, (2) allowing employers some options to raise and lower benefits, (3) determine retirement benefits on the basis of employee account accruals, (4) create flexible processes for annual allocation of the investment return, (5) set aside reserves for use in lean years or to offset sudden unexpected events, (6) provide employers with options for managing some of their own risks, and (7) maintain oversight over and actively participate in the selection of actuarial methodologies, processes and assumptions. There are undoubtedly other features and strategies that have been conceived and implemented elsewhere — or that will be developed in the future in response to new needs or circumstances.

Consolidation of Smaller Plans. By consolidating or merging smaller single-employer plans into multiple-employer plans, the advantages of size can be gained. If the larger plan is already established, the savings are likely to begin accruing immediately. However, there are tradeoffs: control may be lost; the available plan provisions may not be all that is desired; and the plan may later move in undesired directions. This may make such mergers difficult unless there are other overriding benefits for the employer.

Allow Employers to Set Benefit Levels and Adjust Future Benefit Accruals. As taxpayers, we expect our governmental entities to provide services in the most efficient manner possible. To accomplish this requires that our public officials have a wide range of options to meet new challenges as they arise. This flexibility is exceedingly important in the area of compensation and employee benefits.

The level of retirement benefits provided must be variable and established in concert with compensation and other employee benefits in order to efficiently meet the needs of the employees — and the public. Any attempt to predict the future in order to accurately calculate the obligation that will result from a predefined level of retirement benefits will fail — a result of too much uncertainty.

Likewise, the employer must have some control over the level of benefits applicable to future employment service — just as they must have control over what skills and experience are employed to most effectively meet the public need and properly control costs. While some may view flexibility in the accrual of future benefits as just an

opportunity for employers to reduce benefits and being subject to abuse, that has not been my experience. I have observed that employers are more inclined to increase benefits when they know that they are not locked in forever regardless of what the future holds. I have also seen far more cases of excessive retirement benefits than the reverse.

When funding sources are tight, it also makes little sense to insist on maintaining a particular level of retirement benefits at the expense of health care benefits, which may currently be a more critical need of both the employer and employees.

Promises made that ultimately produce unexpected and unfulfillable obligations seldom benefit anyone — instead they increase individual risks and render a disservice to society. In cases where public entities have privatized in order to walk away from pension obligations, greater flexibility might have been able to produce a better result.

Determine Retirement Benefits on the Basis of Employee Accounts. Public pension plans have traditionally been joint-contributory. Each member has an individual account which usually contains his or her contributions plus some allocation of annual interest or a share of investment income. However, in many cases the balance of a person's account bears no relationship to the ultimate benefit. Without this direct connection, there is very little feeling of ownership by employees. There can also frequently be issues of fairness among peers and tendencies to try to “game” the benefits or otherwise take personal advantage. It is likely that employees under such plans feel less like partners with the employer in preparing for retirement and, consequently, have a greater expectation that the employer should bear full responsibility. Cooperative support is required if uncertainty is to be dealt with most effectively.

Benefits based on the average salary over a working career are less subject to significant shifts in salaries and less likely to produce sudden increases in employer contributions. Admittedly, employee benefits would not maintain pace with salaries, but a return to the inflation of the 1970's would create major funding problems. A more satisfactory result might be to anticipate that the employees might have to work a bit longer to make up the difference, and recognize that now and in the future, retirees will actually be the group most vulnerable to inflation.

If benefits are a function of personal accounts, the employer obligation is normally also defined as some function of the employee account. Under this arrangement, defining the total benefit value at any point in time is not an issue. There is also a direct relationship between the productivity of the employee (as defined by compensation) and his or her retirement benefit. This is a very intuitive and logical definition of fairness.

Provide a Flexible Process for Allocation of Investment Return. Investment return is either the most volatile area of pension plan finances, or the pension plan is forgoing a large amount of investment opportunity in order to provide stability — or at least the appearance thereof. For most, the idea that a person's account could be less than it was the previous year is unacceptable. Therefore, employees must be protected somewhat against the full brunt of market volatility. When this is done, the plan (and ultimately the

employer) must bear additional risk — making the employer more vulnerable to rate increases.

It is exceedingly difficult to conceive of all possible scenarios and plan in advance the most prudent and fair method for allocating income. Attempts at codifying usually produce unintended and undesirable consequences sooner or later. This is particularly true when it is important to take into consideration last year's results or make provisions for future possibilities. Therefore, it can be extremely useful for the board of trustees to consider all options when most or all of the actual results are known and the consequences can be measured.

Set Aside Reserves for Lean Years and the Unexpected. One income allocation technique that has been successful in bridging short-term return volatility is to set aside reserves during the good years for use in smoothing the impact of ones with poor results or to cushion the effects of other change. These reserves would not be included in the actuarial value of assets for rate setting purposes but could be allocated later to make up market shortfalls, help offset the initial impact of actuarial losses due to a change in an actuarial assumption, or provide a transfer to pooled annuity reserves to offset unexpected mortality losses.

Reserves are not a panacea. There are always questions like “how much is enough?” and “how much is appropriate to be excluded from the employer rate calculations?” And it is always difficult to determine when to hold reserves and when to release them.

Provide Employer with Options for Managing Risk. Each employer will not necessarily have the same tolerance for rate volatility. In some cases, the best solution for one employer may not be the best for another. Therefore, options which allow the employer to partner with the pension plan for risk mitigation should be provided within the plan provisions. Generally, these would involve the tradeoff decisions that are best decided by the employers. For example, an employer could opt to contribute at a rate somewhat higher than the required rate (without making a long-term commitment). This would provide a buffer against future rate volatility, fund the obligation faster, and in the case of a major increase in required rate, diminish the immediate budget shock. The tradeoff would be the reduction in current funding for other budget items. The employer has the option to give up current funding or take on a greater risk. However, by being a partner in the decision process, there is greater employer satisfaction regardless of what the future outcomes are.

Monitor and Participate in the Actuarial Process. Public pension actuaries are highly professional, must comply with a wide array of professional guidelines and are subject to effective peer oversight. However, their role is daunting and one that is compounded by the fact that each public plan is different in design, philosophy, goals and priorities.

The role of the actuary is so central and so important that each pension plan not only must monitor the work of the actuary and provide appropriate input and oversight, but it must actively participate in the selection of methodologies, development of unique

processes, and evaluation and adoption of appropriate assumptions. The actuary's role on the funding side is similar to the investment advisor and money managers' roles on the asset side.

By being as involved in the funding as has traditionally been the case on the investment side, it is much easier for the plan board and staff to insure that the funding policies and investment policies are compatible — thereby reducing risks. It is equally important that the board and staff be aware of the likely impact of any change in one area on the other area. Greater understanding promotes more options and fewer risks.

Dealing with uncertainty requires identification of those areas that most likely will have the greatest impact on the plan, development of possible strategies for mitigating the impact, and thorough testing of each strategy prior to its adoption and implementation. All too frequently, change is made without effective and thorough testing. This generally increases risk rather than reduces it. With the computing tools, computer power and historical data so readily available today, there is little reason to keep any large pension plan from being very aggressive in this area.

Beyond Plan Design

The focus of this conference is on basic plan design and some aspects of high-level pension policy. While these form the foundation for public pension funds, no one benefits until these have been effectively implemented, evaluated, and modified over long periods of time. To complete the process, there are several other areas (involving all stakeholders) that must be addressed. These include (1) good governance, (2) professional administration and communication, (3) professional money management, (4) forward-looking decision support capabilities, and (5) clear, long-term strategic directions. Public pension plans are financial services organizations, and as such they must be forward-looking, learning organizations with the ability to recognize and negotiate future risk and change.

Conclusion

It is important for all public pension plan stakeholders — employees, employers, retirees and their survivors, and the public — to recognize that change is accelerating and uncertainty is increasing. To remain viable, pension plans must meet the needs of all stakeholder groups. To accomplish this, employee benefit accumulation must be fair and relevant; employer costs must be reasonable and non-volatile; retiree benefits must be adequate and assured; and the public must be continuously comfortable with both costs and benefits.

Public pension plans are something of a paradox. They are charged with planning for and ensuring the attainment of the plan owners' long-term financial promises to the beneficiaries of the pension trust with predictable and uneventful funding by employers. All of this must be accomplished while navigating an ever-changing political, economic, and cultural environment. In other words, give the appearance of a duck gliding smoothly

across a seemingly calm river without any indication of the currents, frantic paddling or dangers lurking beneath the surface.