

PUBLIC SECTOR PENSION PLANS  
Current Challenges and Future Directions  
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**Verbal Remarks for Presentation on  
Public Plan Design for the Future  
by Ray Henry**

**Slide 1**

The subject of public pension plans is both broad and complex. Each public plan — each set of public employers — and each group of public employees are all different. And all of these will change over time.

I have been asked to highlight some of the areas that I believe will be the most critical for public plans in the future and to identify issues that are deserving of additional discussion.

Public pension plans today are facing new challenges and increased scrutiny. The relative obscurity once enjoyed by most plans is likely gone forever. But visibility also provides the opportunity for debate among all stakeholder groups and the opportunity to forge better solutions for the future. Only through stakeholder partnerships can public pension plans be assured of success.

**Slide 2**

The future for public pension plans revolves around two key areas.

1. Benefits must be both adequate and secure.
2. Employer funding must be sufficient in the long-term and manageable in the short-term.

Meeting all of this on a continuous basis will require a sharing of risks and will likely be satisfied most easily by hybrid forms of defined benefit plans.

**Slide 3 (Critical Employee Needs)**

In looking first from the employee perspective, the most critical need is of course adequate benefit levels. But beyond that, it is important that each individual receives protection against:

1. individual risks,
2. the loss of earned benefits, and
3. post-retirement inflation.

Annuities protect retirees against living too long, and because public pension plans can provide annuities at cost, the value of retirement savings is maximized. In a recent comparison, I found that \$500,000 will produce an annual annuity of \$42,000 for a couple aged 65 in a public plan, but the same annuity in the private market requires over \$640,000 — or 28% more.

Another area of individual risk is in the accumulation and liquidation of retirement assets. Public plans have access to better expertise and can invest at substantially lower costs than individuals. And because plans include persons in the accumulation phase, as well as retirees, cash flow and short-term market issues are more easily managed.

The average individual faced with long-term money management is disadvantaged due to the complexity, lack of expertise, and costs.

It is also important for employees to have an opportunity to preserve earned benefits when changing jobs and when jobs are lost. These benefits should not be fixed at termination. Instead they should be fairly valued and increase, thereafter, by future investment earnings and age changes.

Inflation has become the second most important issue — following healthcare — for persons who are retired or approaching retirement. The impact of even modest inflation can be devastating.

For example, only 2% inflation will reduce the purchasing power of a dollar to 75 cents in 15 years; 3% inflation produces the same result after only 10 years. 3% inflation will also cut the value of retirement checks in half in 24 years; and 4% inflation has the same effect in only 18.

Even short periods of higher rates of inflation can have a major impact. For example, 6% inflation for only 4 years would result in a 20% loss of purchasing power.

Maintaining the purchasing power of retirees is an area that needs attention. Good solutions will require a sharing of the risks between the employer and retirees.

#### **Slide 4 ( Meeting Employer Funding Needs)**

Most public plans are successful in their efforts to minimize costs, and maximize investment return.

**employer contributions = employee benefits + administrative expenses – investment return – employee contributions**

As shown by this general funding formula, a dollar less in expenses or a dollar more in investment return is a dollar that the employer will not have to contribute or a dollar of additional benefits that can be provided.

Beyond this, successful funding requires that the short-term and long-term financial needs both be met — without one disrupting the other.

From the long-term perspective, sufficient assets must be accumulated to meet the promised obligations. It is also prudent to ensure that the assets be accumulated on a schedule consistent with the earning of benefits.

On the short-term funding side, employers must operate within budget constraints and maintain public support. Employers must also consider the current needs of the employees, as well as their longer term needs. For example, it may make little sense to continue to provide generous retirement benefits when faced with major cuts in employee healthcare insurance.

It is important for the employers to be partners in the funding decisions. Each employer should have some control over the level of benefits to be earned in the future.

However, there will also be economic, demographic and even cultural surprises as the plan moves toward its distant funding objectives. It is important for the pension plan to identify which possible events present the greatest funding risks, and actively develop ways to manage their impact.

As an example, we know that capital markets will have major short-term swings and that these will place significant pressure on the employer contribution rates. Therefore, when considering investment policy it is important that funding policy also be considered — and modified if necessary. In the public pension sector, investment risk is not defined by the portfolio mean and standard deviation, but rather, by the effect of market volatility on the employer contribution rates.

For employers, it is critical that the pension plan has public support. Without it, neither the plan trustees nor the elected officials can be effective in achieving good long-term results.

### **Slide 5 (Critical Factors in Maintaining Public Support)**

Maintaining public support on a continuous basis always requires a high level of financial competence, ethical behavior, and public stewardship.

In addition, public pension plans and their employers must also ensure:

1. that benefit levels are appropriate and easily justified,
2. that employer costs appear to be reasonable for the long term, and
3. that employer contribution rates are sufficiently stable to avoid budgetary issues that spill over into public debate.

To accomplish this, the pension plan must, over long periods of time, successfully navigate through ever-changing political, economic, demographic, and cultural environments.

Success really begins with the pension plan's culture. The most successful plans will —

1. embrace change and be forward-looking,
2. be proactive, rather than reactive,
3. strive to partner with all stakeholder groups,
4. promote effective two-way communication,
5. identify future risks,
6. find opportunities to lower risks, and
7. create flexible funding mechanisms.

It is unlikely that a single event will be sufficiently disastrous to cause a sudden loss of public support. But for plans already burdened by past events and poor decisions, a single event can become a tipping point — precipitating an unwinding of plan stability and causing significant unintended consequences. We have seen this occur a number of times in the last few years. Historical burdens already exist within many public pension plans today. As a result, I believe that risks are greater now, than they have ever been.

The ultimate solution does not lie within a single strategy optimized for the most likely future. To do so creates even greater risk, because even the most likely future has a very low probability. The opportunity for avoiding a tipping point is increased by strategies and plan designs that work well enough across a broad range of possible futures. Success is really a matter of avoiding disaster over the long term.

#### **Slide 6 (Sample Techniques for Meeting Funding Needs and Reducing Risks)**

Methods for enhancing funding flexibility and mitigating risks are as varied as public pension plans. This slide lists a few that I have seen successfully utilized. Each raises additional questions and opens other issues — too many to discuss here today. I have included brief comments about each in a paper within the conference materials.

In conclusion, I would like to leave you with a thought about the nature of public pension plans and the paradox that exists. It is the resolution of this paradox that will challenge public pension plans in the future.

Public pension plans are charged with attainment of long-term financial promises made to the beneficiaries of the pension trust with employer funding that is both predictable and uneventful — all within an evolving political, economic, and cultural environment.

To translate this into an image —

#### **Slide 7**

*One could say that public pension plans must give the appearance of a duck gliding smoothly across a seemingly calm river without any indication of the currents, the frantic paddling, and the lurking dangers beneath the surface.*