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AMERICAN ACADEMY *of* ACTUARIES

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July 31, 2012

The Honorable Orrin Hatch  
SH-104 Hart Senate Office Building  
Washington, DC 20510-4402

Subject: State and Local Government Defined Benefit Pension Plans

Dear Senator Hatch:

In the Senate Finance Committee Ranking Member Report issued earlier this year, “*State and Local Government Defined Benefit Pension Plans: The Pension Debt Crisis that Threatens America*,” you address the threat these plans pose to the financial stability of state and local governments and to the retirement security of millions of their workers and retirees. This issue is serious and controversial, and we commend you for addressing it and for your commitment to solve the problem.

Virtually all retirement systems have faced difficult challenges during the recent financial crisis and recession. Critics of defined benefit plans sometimes point to such challenges and suggest the solution is to eliminate them. In a time of challenging economic and financial trends, this may seem to some like a reasonable solution, but it comes at a significant cost to participants and taxpayers and is almost certainly an overreaction.

Pension plans are capable of operating effectively through severe crises. With proper governance and by pooling and managing risk, these plans can provide participants with a secure and steady income through extreme economic conditions. Taxpayers can be well-served by these plans, which deliver this economic security at a reasonable cost when effectively managed.

The Pension Practice Council of the American Academy of Actuaries<sup>1</sup> appreciates meaningful proposals that develop long-term solutions to pension financing problems and that recognize the unique characteristics of these plans. To help you craft such a proposal, we offer these comments with respect to certain aspects of your report.

### **Essential Goals**

In general, we support the four essential goals you identify for public pension reform: affordability and transparency, generational equity, retirement income security, and state and local funding. But, these goals can create internal conflicts. Programs should be affordable, for example, but assuring

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<sup>1</sup> The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

retirement security is not inexpensive. Likewise, assuring future taxpayers have no liability for past years can conflict with goals of affordability or retirement security.

Pension plans should fund all obligations in a transparent, reasonable and rational fashion, seeking to minimize cost and, ideally, to allocate that cost to taxpayers who benefit from the services of the workers. But, guaranteeing future taxpayers that they will have no liability can increase current contributions and might result in future generations paying less than their share of retirement costs. Maintaining some flexibility regarding this goal tends to reduce aggregate contributions to the plans.

### **Suitability of Defined Benefit Plans for State and Local Governments**

State and local governments, as well as society as a whole, have an interest in ensuring that retirees have an adequate lifetime income. This interest is particularly acute in localities in which the employees of the state or local government are not covered by Social Security. Without a defined benefit plan, individuals have few effective tools to deal with the challenge of securing lifetime income for themselves. The efficiency of providing lifetime income through a defined benefit plan can be significant.

Defined benefit pension plans create value by pooling risk, particularly longevity risk, among a large number of participants. In addition to the advantages of pooling longevity risk, defined benefit plans pool investments and manage these investments professionally. The net investment returns of professionally managed defined benefit plans typically exceed those of individually managed investments by significant margins.<sup>2</sup>

Some pension plans may have taken on more risk than they can sustain or have other governance issues, but this does not imply that all defined benefit plans are unsuitable for state and local governments. These plans can be effectively maintained by state and local governments. Improving the funding and governance of many public plans will not be easy, but the benefits of doing so are substantial for both plan participants and taxpayers.

### **80 Percent Funded Ratio**

The Ranking Member's report states that "...80 percent is generally considered the indicator of a sound government pension plan." While there is no single, accepted definition of a sound pension plan, funded status, by itself, is an inadequate measure of the financial strength of any pension plan. An assessment of the financial health of a pension plan needs to take into account the availability of resources to support the plan compared with the expected cost of the plan and the risk of variation in that expected cost.

A funded ratio is a single measure of a plan's status at one point in time. No single funded ratio should be used as a measure of a pension plan's financial health. Funded ratios should be scrutinized over several years to examine trends and should be viewed in light of the economic situation at each point in time. Higher funded ratios are expected following periods of strong economic growth and investment returns such as that experienced at the end of the 1990s. Lower funded ratios are expected after recessions such as the one begun in 2008 or after years of poor investment returns. Whether or not a particular shortfall affects the financial health of the plan depends on many other factors.

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<sup>2</sup> See "Investment Returns: Defined Benefit vs. 401(k) Plans" Center for Retirement Research at Boston College, September 2006 and "DB Versus DC Plan Investment Returns: The 2008-2009 Update" Towers Watson March 2011  
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Other measures of financial health should be examined in addition to funded ratios. These may include:

- Size of the pension obligation relative to the financial size (as measured by revenue, assets, or payroll) of the plan sponsor.
- Financial health (as measured by level of debt, cash flow, profit or budget surplus) of the plan sponsor.
- Funding or contribution policy and whether contributions actually are made according to the plan's policy.
- Investment strategy, including the level of investment volatility risk and the possible effect on contribution levels.

Again, each of these measures should be examined over several years and in light of the economic environment.

Well-governed plans should have a funding policy in place to meet the full costs of these plans as well as a history of adhering to this funding policy. Lack of a funding policy or a demonstrated failure to adhere to a funding policy raises serious concern.

Using 80 percent as an “indicator of a sound government pension plan,” as stated in the report, also introduces the potential that some will consider 80 percent funding a goal or target, rather than targeting 100 percent or greater. Such a reduced goal likely would impose an additional cost on future taxpayers and could subject a plan to severe stress in economically troubled times.

The American Academy of Actuaries' Pension Practice Council has just published an issue brief addressing this issue, [\*The 80% Pension Funding Standard Myth\*](#).

### **Exhausted Assets**

The Ranking Member's report also states that “...the pension plans of 11 states are projected to have exhausted all of their assets by 2020,” and cites a 2009 paper as the source of this projection. The 2009 source paper uses questionable assumptions and simplistic methods to make this assertion. For example, the paper assumes that each plan sponsor would contribute only enough to fund newly accrued benefits, and that none of these funds would be available to pay current benefits. Ten years later the plans are projected to “run out of money” only because the intervening 10 years' worth of contributions plus income (well over \$1 trillion in aggregate) are simply assumed to be unavailable to pay benefits. As the GAO noted, “The projected exhaustion dates are thus not realistic estimates of when the funds might actually run out of money.”<sup>3</sup>

To illustrate the problem with these projections, consider the state of Oklahoma, which in the report was projected to exhaust its assets in 2017. The June 30, 2011 actuarial valuations for the two largest plans in Oklahoma report assets of approximately \$17 billion and benefit payments during the prior year of approximately \$1.5 billion. Contributions for the prior year were approximately \$1.2 billion. If benefit payments continue to exceed contributions by \$300 million, these plans have sufficient assets to last more than 50 years without any investment earnings. Even if benefit

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<sup>3</sup> “State and Local Government Pension Plans: Economic Downturn Spurs Efforts to Address Costs and Sustainability,” United States Government Accountability Office, March 2012, page 12.

payments increase and contributions do not, these plans are not likely to exhaust their assets soon and certainly not by 2020.

The source paper referenced should not be used as the basis for assessing the potential threat that state and local government-sponsored pension plans might pose to their sponsors.

### **Summary**

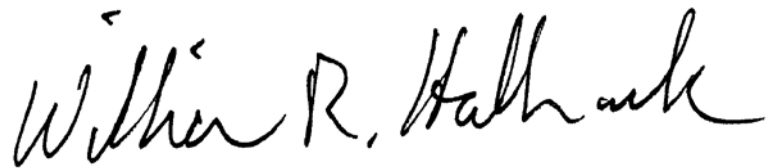
The Academy's Pension Practice Council supports your goal of having state and local government pension plans that are affordable, that provide transparent costs, appropriate allocation of costs to all taxpayers (current and future), retirement income security for employees, and full and complete funding by the sponsoring entities. The Academy's professional staff stands ready to help craft policies to support these goals.

We would be happy to discuss any of these items with you at your convenience. Please contact Donald Fuerst, the Academy's Senior Pension Fellow (202-785-7871, [fuerst@actuary.org](mailto:fuerst@actuary.org)) if you have any questions or would like to discuss these items further.

Sincerely,



John H. Moore, MAAA, FSA, FCA, EA  
Vice-President, Pensions



William R. Hallmark, MAAA, ASA, FCA, EA  
Chair, Public Plans Subcommittee