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CURRENT ISSUES IN PUBLIC EMPLOYEES PENSION PLANS

*Moderator: CONRAD M. SIEGEL. Panelists: ALBERT ALAZRAKI, EDWARD W. BROWN, RICHARD G. ROEDER**

1. Should they be subject to ERISA?

2. What was the extent of compliance with IRS Form 5500 filing for 1976?

3. Will the New York experience of investing in employer-related securities with Federal Government blessing spread to other governmental funds? Are cash flow models used to illustrate the effect on benefit disbursements of postponement or default of principal and interest payments?

4. Recently, proposals have been made to use less conservative actuarial cost methods, either to liberalize benefits or to reduce costs. What responsibility does the actuary have if he is asked to endorse the weaker approach?

5. Public employee plans are now submitting to actuarial audits. What is the function of the reviewing actuary concerning data quality? assumptions? funding methods? benefit adequacy?

6. What are the responsibilities of the actuary in commenting on benefit design? Should he provide a range of uncertainty when developing cost estimates for "bad" design?

7. What is the status of current multi-plan funding studies (statewide, regional and national)?

MR. CONRAD M. SIEGEL: Our panel consists of chief actuaries of two large statewide retirement systems and two consulting actuaries who are involved with many state and local government plans throughout the East, Mid-west and West. The first topic, problems of coverage under ERISA, has been treated extensively in the past; we will, therefore, concern ourselves only with items of special interest to our panel or participants. In testimony before the Dent-Erlenborn Committee one of my clients suggested that if plan termination insurance were applicable to public plans, his own city would present itself as the first claim and that he would be delighted if the U. S. Government would accept 30% of his sewer system, 30% of his streets, and 30% of his other problems.

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MR. RICHARD G. ROEDER : Our firm has established funding standards based upon funding accrued liabilities as a level percentage of payroll. This is accomplished by explicit actuarial assumptions, including a substantial allowance for inflation in determining the liabilities. ERISA's requirement of level-dollar amortization over periods of 30 or 40 years would be inconsistent with the determination of liabilities.

MR. JAMES B. GARDINER: What happens if the aggregate payroll begins to go down? How is the funding going to be completed?

MR. SIEGEL: Since this topic will be discussed in greater detail under topic 4, I would like to defer the answer to that question.

MR. EDWARD W. BROWN: The New York State Employees' System would have its greatest problems with ERISA compliance in connection with disclosure to employees. We think we do a good job in that area, but would not comply with ERISA. We have many different individual employers and different types of covered employee groups, and do not think we would have much difficulty in meeting the funding requirements.

MR. SIEGEL: The second topic concerns the 5500 filings for 1975 and for 1976 by public employee plans.

MR. ROEDER: Philosophically we are concerned with the intrusion of the federal government into state and local government retirement matters. For some time we did not give our clients any definitive guidance in the matter. Eventually we suggested that those plans that did wish to file do so, with the following statement under the signature: "This form is being filed in a spirit of cooperation and is not an acknowledgement of jurisdiction." Many of our clients were still inclined not to file, but the recent news releases from the Internal Revenue Service have brought most of them into line.

MR. ALBERT ALAZRAKI: The New York State Teachers' Retirement System is filing the 5500 form with a similar disclaimer. We have approximately 900 individual school districts and we did not want to file 900 individual forms. We are filing just one form.

MR. SIEGEL: A small town in Pennsylvania (which has approximately 1600 plans out of the 6,000 plans in the country) was assessed a substantial penalty for late filing by the IRS. Many of these plans are one or two-man police pension funds. I think the recent IRS announcements are comforting under the circumstances.

MR. ROBERT M. MAY: I understand that legislation has been introduced in the Senate to exempt governmental plans from the reporting and disclosure sections of ERISA.

MR. ROEDER: Senator Stone has introduced such a bill. The Municipal Finance Officers Association is sympathetic to the bill. However, the bill has very little support.

MR. SIEGEL: I would like to start topic 3 with comments from New York City by its Chief Actuary, Jonathan Schwartz.

MR. JONATHAN SCHWARTZ: The public perception of recent actions by the Trustees of New York City's retirement systems is that the corporate securities from the systems' portfolios have been replaced by City-related securities. This is not the case. On December 31, 1974, immediately before the City's credit was shut off, the retirement systems held roughly \$7.70 billion of assets, of which \$7.35 billion represented corporate securities and \$.35 billion (\$350 million) was City-related paper. In other words, about 4½% of the systems' portfolios was invested in securities of the employer, representing old 2%-3% coupon bonds which were really not marketable.

When it became impossible for the City to borrow from any other sources, the retirement systems purchased about \$650 million of Municipal Assistance Corporation securities in the summer of 1975, and later agreed, in November of that year, to purchase \$2.5 billion of City bonds between December, 1975 and June, 1978. Subsequently, the systems were exempted from \$125 million of this commitment.

As of June 30, 1978, I estimate that these portfolios will amount to roughly \$10.75 billion, of which approximately \$3.55 billion will be in City-related securities. Although it is true that the proportion of employer-related securities in the portfolios will have increased to about one-third, the corporate securities will have decreased from \$7.35 billion to roughly \$7.20 billion, i.e., by about 2%. In other words, virtually the entire purchase of \$3 billion of City-related paper will have been financed from surplus cash flow rather than from liquidation of corporate securities.

With regard to the possibilities of the February, 1976 Congressional legislation serving as a precedent for other public employers, that legislation states that no retirement system which participated in the November, 1975 agreement would be deemed to be in violation of the prohibited transaction sections of the Internal Revenue Code by virtue of having been a party to that agreement. The Ways and Means Committee made it quite clear at that time that this legislation was not intended to serve as a precedent for any other public employer.

MR. SIEGEL: Have other communities looked to their pension funds when they are unable to sell securities in the markets or are having trouble balancing their budgets? Are actuaries doing cash flow projections to indicate what proportion of benefit payments are to be made from interest and principal payments on employer securities?

MR. BROWN: The New York State Employees' System did purchase some New York City and New York State obligations, but not nearly to the extent that the New York City System did. I do not think the maximum percentage exceeded 10% of assets, and as of now, those securities have all matured or been sold. We have had a number of other towns and cities asking that we purchase their securities but we have declined to do so; obviously we are being hypocritical. Mr. Alvin Lurie of the IRS recently stated that New York City's request (which was subsequently granted) for special legislation indicates that the IRS does have jurisdiction over state and local government retirement plans.

MR. ALAZRAKI: The New York State Teachers' Retirement System reluctantly invested approximately $½ billion in New York State and New York City obligations. We have since tried to liquidate these assets as quickly as possible.

MR. SCHWARTZ: Pursuant to Mr. Brown's comment that the IRS has interpreted the City's request for Federal legislation as proof positive that public retirement systems are subject to its jurisdiction, there were those of us who argued in late 1975 that the City should not have approached the IRS at that time for precisely that reason. I do not feel that the IRS has jurisdiction over public plans.

In addition, it should be pointed out that the factors considered by the State and City systems in determining whether or not to purchase New York City securities were really quite different. The rationale for the purchase by the State systems was apparently the fear that a New York City bankruptcy could conceivably lead to a closing of the State's credit markets. However, in November of 1975, there was a clear and present danger of an imminent City bankruptcy, which could have resulted in an indefinite cessation of employer contributions to the City's retirement systems. In that event, it would have been necessary for the retirement systems to immediately begin liquidating assets in order to pay benefits. This would have resulted in a much larger diminution in the systems' corporate securities than the small reduction which has actually occurred.

By way of summation, I think it is fair to say that the Trustees of New York City's retirement systems did not precipitously abandon their fiduciary responsibilities in order to bail out the City. Rather, they made an intelligent choice among several imperfect alternatives; the alternative finally chosen essentially entailed an agreement to invest surplus cash flow in City securities until June 30, 1978, in exchange for a guaranteed surplus cash flow during that period.

MR. SIEGEL: Our interest in the fourth topic, less conservative actuarial cost methods, has been highlighted by recent events in New York State. Many of the persons involved are present at this session.

MR. ALAZRAKI: The New York State Teachers' Retirement System uses a funding method which can be described as aggregate funding in conjunction with a 25-year indexed amortization of the liabilities associated with benefits enacted in 1968, 1969 and 1970. The indexing is at the rate of 4% per annum. During the first two years the results are essentially similar to interest only. After two years the principal begins to be amortized, and finally at the end of 25 years the liability is liquidated.

In 1976, as a result of budgetary difficulties in New York State, the New York State Budget Division proposed a refinancing of the past service liability. What was proposed was a 40-year amortization instead of the original 25 years and an increase in indexing from 4% to 5%. It was proposed that the initial liability should be determined by the entry-age normal cost which pertains only to new members. This may require some explanation. There is a three-tier benefit structure in New York State. A rich plan of benefits is provided for pre-1973 entrants, a reduced scale for those entering between 1973 and 1976, and a further and very substantial reduction for subsequent entrants. The State's constitutional guarantee is such that no reduction or impairment of benefits can be made for an existing group of employees. Hence, the three tiers. The Budget Division's proposal was that all members be considered as having the normal cost appropriate for new members. This produces a very large unfunded liability. For 15 years the unfunded liability would continue to grow. It would not return to its initial level until 26 years hence. Examining the age of the individuals, it could be observed that the funding of the obligation would not have begun until most of them had retired and would not have been completed until many of them had died. The level of funding might be characterized as something below pay-as-you-go. Many different views were expressed on the matter. The Retirement Board heard several actuaries and the Board then opposed the proposal. The proposal was not enacted by the New York State legislature.

The New York State experience indicates that the temptation is great to solve "one-time fiscal crises" by an alteration of the funding method. These one-time crises, of course, have an annoying habit of recurring from year to year.

MR. THOMAS P. BLEAKNEY: I find myself in an awkward position apparently advocating weaker funding, since I was on the other side of that matter. I was retained by the Budget Division to evaluate an earlier proposal which I felt was highly inappropriate. I suggested as an alternative the 40-year level percentage amortization. As to the normal cost determination, it is unusual that this situation does involve a reduction in benefits. Since the normal cost utilized is in fact, the ultimate normal cost, it makes sense to me. Since the present benefit structure has been such a burden on the state, the concept of having a flow of funds into the system which is relatively level, but asymptotically approaching the ultimate normal cost, is a reasonable approach. The question was raised as to whether a level percentage of pay amortization is allowable under ERISA. It is not appropriate since governmental plans are not subject to ERISA funding rules.

MR. SIEGEL: It might be worthwhile to look at the actual experience of one large system that adopted this funding method ten years ago, thereby accomplishing a 70% increase in benefits without increasing employer contributions. The use of static actuarial assumptions resulted in very substantial actuarial losses. Since the funding method funds such actuarial losses on an index basis, the effect of the losses is deferred for some years. In this system, however, the costs are beginning to catch up to the actual experience and the total employer cost, as a percentage of payroll, has risen very substantially. It is important that the particular funding method used be examined very carefully in the light of the actuarial assumptions.

MR. SCHWARTZ: At present, those concerned with public sector matters are trying to determine what can be learned from New York City's recent experience. It would seem to me to be readily observable that (1) using less conservative actuarial cost methods increases employer costs in the short run, and (2) one-shot cost reductions have a way of generating nearly irresistable momentum in subsequent years. The first point is illustrated by the fact that the well-publicized round of New York City benefit increases in the late 1960's was preceded by both an increase in the valuation rate of interest and a lengthening of the amortization period for unfunded accrued liabilities. Both of these "cost reductions" contributed greatly to the pressure to grant benefit increases, the cost of which exceeded the savings due to these reductions. The second point deals with the events leading up to one of New York City's better known budget balancing "gimmicks" that occurred in 1975, namely, offsetting the City's pension contributions in a single fiscal year by the sum of interest gains from three fiscal years. At the time this was done, I pointed out that, rather than representing an aberration, this action was really the culmination of several "cost-saving" actions in prior years, many of which were at least as sound theoretically as the procedure described earlier by Tom Bleakney. Based on the New York experience, I would say that it is very difficult in the public sector to reduce pension contributions once and only once, since there is a considerable risk of setting off a chain reaction.

MR. THOMAS D. LEVY: In the New England area we have been involved in several similar situations in the past few years. In Rhode Island we convinced the Board that we should use explicit assumptions across the board, even though the prior actuary had not done so. The full actuarial cost is reasonably close to his figures, but the normal cost is lower and the unfunded liability higher. The funding statute provides for a phasing in of the full actuarial cost and currently requires 68% of the normal cost and 32% of the interest on the past service liability. These percentages grade up to 100% over a number of years and then provide for a 30-year amortization. The result of our using explicit assumptions produced a reduction in required contributions, due solely to the funding statute, which was based on the general level of the figures provided by the prior actuary. Our recommendation was to change the statute.

In Connecticut two interesting proposals were made to help provide money for employee pay raises. One involved delaying the progression in an increasing percentage of cost schedule and the other involved cutting benefits for employees retiring more than five years hence, while reflecting the costs immediately. Fortunately, the Chairman of the Retirement Commission was an actuary and the proposal did not proceed much further.

Massachusetts has had very little funding beyond pay-as-you-go. Recent legislation requires funding. An interesting sidelight to level percentage amortization of past service occurred. We used a 3% inflation rate and a 3% indexing. The concensus was that inflation would be higher than that. We then recomputed it at 4½% and found the cost went down because of the indexing of past service. We also found that older communities with many pensioners did not have to put in more than they were already putting in for some years. Young growing communities, however, had to double or triple their contributions. This was due to the fact that the pay-as-you-go level for cities such as Boston had already risen to well in excess of normal cost. If your funding method provides for a relatively low initial contribution towards past service, you should be sure that you are at least contributing the pay-as-you-go costs.

MR. ROEDER: I think the key actuarial role of shifting to weaker assumptions has to do with power and the role of the actuary as a technician in the process of exercising such power. We call actuarial assumptions "financial assumptions" and we feel that the retirement boards have the ultimate responsibility to make the decision on what those assumptions should be. I think that as long as the actuary is allowed to fully express what he feels about the change in assumptions and can state exactly what he perceives to be the strengths and weaknesses of that change, he has fulfilled his basic responsibilities.

MR. SIEGEL: Let us turn now to topic 5, the question of actuarial review.

MR. ROEDER: The number of plans that we are asked to review, and the number of our plans that are reviewed by others is increasing. Perhaps it is part of the post-Watergate era. We have been shocked by what we have found in our reviews of some other actuaries' work in recent years. I now believe that the responsibilities of the actuarial profession in policing itself are really no different from those of the medical profession, law, accounting, etc.

We were asked to audit the actuary's report on a state-wide system. We requested a copy of the data used in the last regular valuation. After months of delay we finally made a visit and found that no such data existed as backup to the valuation. We have seen at least four similar situations. I used to think an actuarial review was a waste of time, but I no longer think so.

MR. LEVY: While I think that actuarial reviews are beneficial, I feel that the reviewing actuary should not come in and do a wholly new valuation with completely new assumptions and that, if the resulting costs are different, state that the present actuary is wrong. The purpose of a review is to determine whether what was done by the actuary is reasonable, and not what you would have done differently had you started the valuation. I think the actuary should recognize that there are legitimate professional disagreements.

MR. BLEAKNEY: On the other hand, the reviewing actuary should make a very strong point as to his position if he feels that the plan's actuary has come up with costs which are substantially different from those that the reviewing actuary feels are appropriate.

MR. SIEGEL: Topic 6 raises the question of the actuary's responsibility for "bad benefit design." This, of course, is a subjective term, and might include benefit design which is highly unstable, such as options which are not actuarial equivalents (e.g., military service buy-backs or heavily subsidized early retirement). Another example of "bad" benefit design is a pension based on the final day's rate of pay (which encourages promotion abuses). These are more prevalent in public plans than private plans. What responsibility does the actuary have when he is asked to price these alternatives? Should he state that he thinks it is a "bad" benefit? Suppose he is very uncertain as to cost, due to the absence of underlying data or uncertainty as to rates of election?

MR. SCHWARTZ: Since our Boards of Trustees also include employee representatives, it is important that the actuary remain able to maintain the trust of both sides of the table. We do attempt to show a range of costs, illustrating several levels of election rates, and do not feel that it is appropriate to classify benefit design as "good" or "bad."

MR. ROEDER: We also like to provide ranges of costs in these uncertain areas, showing both the high and the low figure. If we are cornered into giving one particular figure, we tend to give an estimate near the high end. For a benefit such as early retirement, we show a range of figures for various utilization rates and tell the Board why the cost varies and that we do not know what the degree of utilization will be.

MR. SIEGEL: The seventh topic refers to the status of various multi-plan funding studies that are in process at the present time. The Commonwealth of Pennsylvania recently completed its second set of reports under a law which requires plans with 50 or more members to file every two years, and plans with fewer members to file every four years. A copy of the tabulation of the 1976 reports is available from the Department of Community Affairs in Harrisburg. The contrasts are very marked. The City of Pittsburgh is strictly on an unfunded pay-as-you-go basis, while the city of Philadelphia, as required by its charter, funds on the basis of normal cost plus 100% of interest. Most of the smaller cities are in very poor shape. The counties are extremely well funded since they are statutorily required to use a 4% valuation interest rate and 15-year funding of past service.

MR. BROWN: The Department of Labor has funded a study of retirement systems in New England, covering an 18 month period. The objective is to gather data on all the systems and to do actuarial calculations, but not to take over the actuarial functions for these plans. There will be an attempt to compare plans, one with another.

MR. ALAZRAKI: Howard Winklevoss has a National Science Foundation grant and is conducting a study which will cover plan design. Mr. Winklevoss' objective is to define an adequate level of retirement benefit. Another area he will cover is the need for disclosure and the third area will deal with funding. Approximately 20 public plans will be examined to determine their current funding status and to determine how well those plans would do under alternative funding methods.

MR. ROEDER: The Actuarial Research Foundation has established a committee to study public employee retirement systems and their funding status. The purpose is to disclose the full range of the financial conditions of public employee plans around the country through a very large sampling of plans, i.e., approximately 700 to be selected from the universe assembled by the Pension Task Force. The Committee is Chaired by C. L. Trowbridge and the project director is Robert J. Myers. At present, however, the committee has not succeeded in obtaining the necessary funds to carry out the project. While we have heard of the individual horror stories, both in terms of underfunding and overfunding, we do not have a good perspective on the funding status of the entire universe of plans.

MR. SIEGEL: Mark Twinney has asked that I report on a study of the federal Civil Service Retirement system. He and Dr. Daniel McGill were appointed to a three man advisory panel concerning the actuarial costs of the system. In addition to normal taxpayer concern, there is another facet. Companies bidding on government contracts are compared with the costs of the government doing the work in-house. For this purpose in-house labor costs are loaded 21%. The advisory panel indicated that the minimum add-on costs should be 43%. The Office of Management & Budget then reduced the 21% rate to 14%.

MR. GARDINER: I have a question with respect to obtaining information on the actual state laws for all of the retirement systems in the country. Can you actually get the laws themselves in some convenient form?

MR. SIEGEL: You might try the Pension Task Force. Within each state there are organizations that can get the individual laws for you. For example, in Pennsylvania there is a taxpayer watchdog organization called the Pennsylvania Economy League which has done some studies of state and local retirement systems.

MR. ROEDER: I do not think an overall compilation exists. You have to write to the 50 states and specify the type of plan you are interested in (municipal, state, employees, teachers, police, fire). It is usually easier to get summaries than the laws themselves.

MR. ALAZRAKI: The National Council on Teacher Retirement has a fairly extensive summary of provisions in that specific area. There is also an organization called the National Association of State Retirement Administrators that may be able to help you.