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PUBLIC EMPLOYEE RETIREMENT PLANS

Moderator: ***A. HAEWORTH ROBERTSON.*** *Panelists:* ***E. ALLEN ARNOLD, ROBERT W. KALMAN*, RUSSELL J. MUELLER, JONATHAN SCHWARTZ***

1. What funding standards are desirable for public employee retirement plans? Should they differ from those applicable to private retirement plans?

2. How well-funded are public employee retirement plans according to these standards in item 1, or any other standards?

3. What are the theoretical and practical problems encountered by actuaries in advising on funding matters?

4. What is the prospect for (and the desirability of) federal regulation of funding public employee retirement plans?

MR. A. HAEWORTH ROBERTSON: The public employee benefit field is large and diverse. These are some 6,000 state and local government pension systems, ranging in size from the California Employees Retirement System with assets of more than $15 billion to a small town firemen's system with negligible assets (and relatively large but as yet unrecognized liabilities).

The largest 110 public systems include about 90 percent of all covered employees. There are approximately 150 systems which have 5,000 or more active employees. The latest survey by Pensions and Investments newspaper of the largest 100 fund sponsors included 43 employee benefit systems of state and local governments with assets of $116.7 billion, or 51 percent of the total.

Because of the diversity of public employee benefit systems it is difficult to make generalized statements. It seems safe to say, however, that public employee benefit systems--pension plans in particular--will be the object of more scrutiny and publicity during the next five years than at any time in their history. This will result in a substantial increase in opportunities for consulting, both actuarial and general. It will also result in increased opportunities for actuaries--because of their unique education and experience with pension plans--to play important roles as responsible citizens during this period when public bodies are attempting to rationalize their employee benefit systems.

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MR. ROBERT W. KALMAN:

Introduction

Funding is one of the most burning and most complex issues related to state and local government pension plans. The magnitude of the unfunded past service liability of state and local pension plans has been estimated to range between $150 and $300 billion, and it is growing. Unless this problem is addressed realistically, continued deterioration in the fund status of many of these plans could potentially threaten the fiscal viability of state and local governments and the retirement security of public employees.

The major focus of this presentation will be on one of the four issues listed in the program for discussion at this session:

> Should funding standards for public plans be different from private plan standards and, if so, what standards are desirable for public plans?

In the course of this discussion, naturally I will be touching upon some of the other related funding issues, scheduled for discussion here.

Funding and Public Policy

I will be discussing the funding issue from a broad public policy standpoint, rather than from the more technical, actuarial perspective. From my experience with public pension plans over the last six and a half years, I have found that funding recommendations, in many instances, have been devoid of a broad public perspective. What may appear to be sound funding advice from a theoretical viewpoint or from what has worked in the private sector, may not necessarily be applicable to public plans. This is because of the unique problems that exist in the public sector--budgetary constraints and a declining tax base, to name just two.

Unfortunately, these broader and, I believe, overriding factors, in many instances, are ignored in defining what should be "appropriate" funding levels for public pension plans. The funding policy for a particular state or local pension plan must extend beyond the dollar amounts needed to meet a plan's normal cost and amortize the unfunded liability over a 30 or 40 year period. The situation is more complicated than that. It requires transcending the technicalities of actuarial science and dealing with political and economic forces that are overriding in determining the extent to which a state or local government can fund its pension plan.

Funding Public Plans: Should the Approach Differ from the Funding of Private Plans?

Based upon the preceding commentary, it is obvious that I believe the approach should be different in the public sector. In my view, the goal of full advance funding, as defined and mandated by ERISA for private plans, should not be applied on a wholesale basis to public plans.

In theory, the goal of full advance funding seems to be a very rational and desirable goal for public as well as private plans to meet. However, in practice, it is neither necessarily achievable nor necessarily desirable in the public sector. The magnitude of the unfunded past service liability in many public plans and the budgetary constraints experienced by state and local governments often make full advance funding an impossible goal to achieve.

Massachusetts is a case in point. In October 1976, the Massachusetts Retirement Law Commission and its Funding Advisory Committee issued a report on how the Massachusetts public employees retirement system can achieve full advance funding. This plan, which covers general employees in Massachusetts' state and local government, has been financed by state law on a pay-as-you-go basis since its inception, accruing some $8 billion in unfunded liabilities.

The Retirement Law Commission report appropriately recommended that pay-as-you-go financing of the plan be replaced by advance funding. It favored using entry-age-normal, with full amortization of the unfunded liability over a 40 year period, commencing in 1982, after a five-year phase-in period.

The likelihood that such a funding schedule could be implemented successfully in Massachusetts is remote because it would require public employers in the state to contribute about 25 percent of their annual payroll to the plan. This would be prohibitive in view of the budgetary constraints being experienced by Massachusetts public employers, to say nothing of the prolonged depressed condition of the entire state economy.

Aside from the actuarial explanations for the growth of unfunded past service liabilities--benefit improvements and actuarial losses, for example--unique forces exist in the public sector that make full advance funding an especially difficult goal for public plans to meet. Uncontrollable payroll cost items, such as rising Social Security payroll taxes and health insurance premiums, tend to reduce the scarce dollars available for pension contributions by public employers.

More significantly, competing for the public employer's pension contributions are vital non-payroll pressures--governmental programs, for example, that require additional monies to continue their operation. This has become commonplace, particularly in large urban areas, which have experienced declining tax bases due to the exodus of business and population. Such pressures have intensified the competition for the public employer's "soft" pension dollar.

This problem even arises in states which have statutory funding requirements. In Illinois, for example, state law prescribes specific funding levels for state employee pension plans, which must be maintained by the state government. However, state court decisions have upheld the governor's right to authorize state pension contributions which fall short of meeting statutory requirements.

At the local level, less than 50 percent of plans surveyed by the House Pension Task Force are backed by unlimited general taxing authority. Limitations, particularly with regard to police, fire, and teacher plans, are imposed on local government pension contributions. These restrictions typically take the form of special taxes levied for the specific purpose of financing local pension plans, and fire and casualty insurance premium taxes for financing police and fire plans. However, these tax levies bear no relationship to the funding requirements of the plans for which they are earmarked.

Subsidies by state government to a significant number of plans covering local workers represents another source of public plan revenue, but one which may not be reliable in the future. According to some authorities, state governments may not be under legal obligation to continue ensuring the fiscal viability of these plans.

This eventually may hold true as well with regard to the use of federal grant monies in financing public plans. The House Pension Task Force noted, in its report on public plans last year, that some state and local plans receive federal revenue sharing grant money to pay all or part of a public employer's share of pension contributions. In Delaware, for example, all of the state's federal revenue sharing funds have been used to finance the state's share of contributions to the state employees' pension system.

However, recently Congress almost suspended the federal revenue sharing program. This prospect makes revenue sharing an unreliable source of future financing for state and local plans.

These examples illustrate the anomalies that surround the financing of public pension plans. They demonstrate that public plans are an integral part of the same political process and subject to the same political pressures and budgetary procedures which other governmental programs must endure.

Public plans exist under a unique set of precarious circumstances which make the goal of full advance funding a difficult, if not impractical one for public plans to meet. This is even more apparent today, in view of Proposition 13-type tax limitation measures being considered by state legislatures.

Funding Standards for Public Plans

Funding policy of public pension plans should be based upon whether there is an implicit assumption of perpetual operation of the state or local government employer. The degree to which a particular public plan is to be on a full advance funding basis should depend upon the realistic possibility that the public employer will remain solvent and will have the continuing ability to support its pension plan.

Funding policy should be tailored to the circumstances surrounding each individual plan. Clearly, the normal cost under whatever advance funding method is chosen should be paid each year. However, a grey area exists with regard to amortizing the unfunded past service liability. Should it merely be frozen at the present level by paying the interest on the unfunded liability? Should the unfunded liability be amortized over a fixed period of 30 or 40 years in level dollar amounts or as a percentage of payroll, or even over longer periods of 50 or 60 years, for example? Or, should it be amortized over an unfixed period of time over several generations of taxpayers?

There is no clearcut answer. It would depend upon the magnitude of a public plan's unfunded past service liability and the sponsoring government's ability to amortize it. The sensitive relationship between the monetary requirements needed to amortize the unfunded past service liability and the fiscal health of the governmental employer is central to making this determination.

Where a plan has amassed a large, unmanageable unfunded past service liability--Massachusetts being a case in point--the concept of intergenerational amortization of the unfunded liability appears to be a promising approach.

Intergenerational amortization assumes perpetuity of the state or local government employer. It recognizes the fiscal burdens inherent in amortizing the unfunded liability over traditional periods of time and, therefore, spreads the liability over generations of future taxpayers.

The premise underpinning this approach is that it would be more equitable to allocate the tax burden of amortizing the unfunded liability over many generations of taxpayers, rather than over one generation. In fact, by relating the unfunded liability to annual payroll and reducing the ratio over each successive generation, the relative size of the unfunded liability could be amortized through more manageable contributions, in comparison with contributions required under more traditional periods of amortization.

Additional Measures for Correcting Funding Problems of Public Plans

Responsible funding policy, regardless of the actuarial approach taken to amortize the unfunded past service liability, requires additional measures if public plan funding problems are to be addressed realistically.

Additional actuarial considerations include the use of realistic, preferably explicit, actuarial assumptions, upgraded on a regular basis in accordance with a plan's actual experience and general economic trends. In addition, realistic cost estimates should be presented before benefit improvements are adopted, and these benefit improvements should be amortized over a fixed period of time.

Non-actuarial measures also should be developed and implemented in order to resolve state and local funding problems.

1. Improved Plan Design

Improved plan design, particularly with respect to the future relationship among the pension plan, an employer's other benefit programs, and social insurance programs, would help curb the future growth of the unfunded liability.

2. Consolidation of Small Public Plans

One of the most revealing conclusions of the House Pension Task Force Report was that the bulk of the 6,600 state and local plans are the small local ones, some having fewer than 100 participants. In Pennsylvania alone, the Task Force counted 1,400 plans!

The funding problems of these plans threaten the solvency of small local employers and their ability to provide adequate retirement security to their employees. The diseconomies of scale are self-evident. The proliferation of these plans is irrational from both the employee's and employer's standpoint. These plans should be consolidated, preferably into statewide programs, as in Hawaii and Wisconsin.

3. Enactment of Federal Legislation (PERISA)

Federal regulation of public pension plan funding would be difficult, if not impossible to develop and enforce. Clearly, the mere extension of ERISA's standards to state and local plans may be the final undoing of many of these plans. "The cure may be worse than the disease."

Also, because of the unique circumstances surrounding the funding of many public plans, it would be difficult to apply a uniform standard on a wholesale basis to all state and local plans. Furthermore, federal requirements could be difficult to enforce legally because of the U.S. Supreme Court decision a few years ago in National League of Cities v. Usery. Responsible funding, therefore, should remain, at least for the present and near future, at the state and local government levels.

From a political standpoint, the likelihood of such funding standards through federal legislation appears remote anyway. They were not contained in the PERISA bill introduced last year by Congressmen Dent and Erlenborn,or in the bill expected to be introduced later this year.

What has been proposed and will likely encompass the scope of federal legislation in the public plan area are tough reporting and disclosure requirements and fiduciary standards. Such federal regulation would be an important first step towards promoting responsible funding at the state and local levels, since the crux of the problem with respect to the management of many of these plans has been the secrecy surrounding their operation and financial condition. Federal reporting, disclosure, and fiduciary standards would bring the condition of these plans "out of the closet" and, indirectly, would promote responsible funding by fiduciaries through employee and taxpayer pressure.

There is no reason why actuarial valuations of public plans should not be made at regular intervals and, along with financial reports, should not be available to plan participants, beneficiaries, and the public. And even more fundamental than this, basic booklets, explaining the major benefit and financing provisions of a plan, should be distributed to participants on a routine basis. In addition, these booklets should advise participants where they can obtain further information or have their questions answered accurately.

Summary

In addition to being complex, the funding problems of public pension plans are unique. They require innovative solutions; not merely an extension of what appears to have worked in the private sector.

Public plans should be funded in accordance with sound actuarial principles. Pay-as-you-go financing and terminal funding should be abolished. At the other end of the spectrum, the goal of full advance funding, as defined and mandated by ERISA, may not be appropriate either, particularly where the magnitude of the unfunded past service liability is great. Intergenerational amortization of the unfunded liability may prove to be a more promising and realistic approach.

In addition, an agenda for resolving state and local funding problems should include, at least initially:

1. Use of realistic actuarial assumptions and appropriate funding of future benefit improvements.

2. Improved plan design.

3. Consolidation of small plans.

4. Federal legislation that requires complete reporting and disclosure of plan information and sets fiduciary standards.

This agenda treats the funding of state and local plans as a broad public policy problem, not merely as an actuarial problem. This, I believe, is the approach that will prove successful in resolving the serious funding problems of public plans which, in many cases, threaten the fiscal solvency of public employers and the retirement security of public employees.

MR. E. ALLEN ARNOLD:

An Actuary's Problems with Public Retirement Systems

An actuary has two kinds of problems: Actuarial problems and people problems.

An actuary consulting for or employed by a public retirement system also has two kinds of problems; actuarial problems plus people problems, squared.

Let us look at the actuarial problems first:

Data - on the average, better than multi-employer Taft-Hartley data, but worse than private, single employer data. Solution: if you are a consultant, be careful when quoting fees; in any case, check data carefully and suggest improvements in data system, if needed.

Complexity of plan provisions - requiring the use of more decrements, sometimes more approximations when experience not sufficient, and more programming time.

Plan interpretation - sometimes difficult, and, if so, potentially dangerous. Make sure that the plan you evaluate is the plan, as interpreted by the legal advisor to the system. Otherwise you might not only be fired, but sued.

These actuarial problems are the same kinds as those for private plans, although they often are more severe.

The people problems actuaries encounter, working with public retirement systems, transcend those of private plans. There are three reasons:

First: Politics

Second: The need to satisfy more individuals, committees, legislative bodies and possible conflicting interests, rather than one individual or committee. And

Third: Politics.

Politics is counted twice: internal politics arising from differences on the retirement board, administrative dichotomy and employer-employee conflicts; and external politics as practiced by elected officials and those with special interests. We run into internal political problems sometimes with private plans, but the exposure to this risk is greater with public plans.

Maintaining good client (or employer) relations solves these people problems, but it is not easy. The public actuary is in a fish bowl, and it not as easy as shooting fish in a barrel for politicians and reporters to quote critically any of his statements out of context. His reports and oral remarks before public meetings can easily be mis-used by people whom he has not had a chance to educate, even by people he has not met.

Maintaining good client relations with the sponsors of public retirement systems requires extra effort.

First, of course, is good written communications. An ambiguous report on a public retirement system can lead to immediate, adverse publicity. It is not just a matter of your principal client contact calling up and asking for an explanation. Your principal client contact may not have realized that a problem existed until reading about the system's big new crisis in the newspapers. The solution is to write the best organized, clearest report that you can write in plain English - then have another actuary review it for accuracy - and then, test it on a non-actuary. If possible, review it with your principal client contact before releasing it; he may be able to point out the sensitive areas requiring clarification or amplification.

Oral communication likewise must be clear. When answering a question at a public meeting, remember that your response should not only be clear enough for the board member who asked it to understand, but clear enough so that a newspaper reporter, for example, will not write a story which not only is wrong, but which quotes your response to substantiate the story.

A retirement board usually is responsible for administering all aspects of a retirement system. Its composition is diverse, often including elected and appointed officials, employee representatives and appointed public members. Initially, few of the board members understand pension funding. If they do not understand it fairly well later, they have reached a point of either taking the actuary's word on faith or not trusting him at all.

My experience tells me that an actuary's best course is to work very hard to educate the system's administrator first, if he needs it, and the retirement board, as well, in any case. The board tends to rely on the administrator for advice when in doubt, so the administrator is one key to a successful relationship. The solid support of the retirement board can be expected, though, only when the board understands what the actuary reports to it. And the actuary needs that support, not just for security when internal politics might threaten his position, but as a bulwark of defense against pot-shots from uninformed people playing external politics.

The actuarial profession is responsible for part of the communication problem. Our pension terminology is misleading. Actuarial "liabilities" have too many meanings, and the actuary for a public system must clear up the ambiguities as well as he can.

Another problem of the profession is that different actuaries evaluating the same retirement system sometimes provide widely differing cost estimates. Depending on the circumstances, and the choice of whom to believe, the system might henceforth become either overfunded or underfunded. The problem for our profession is two-fold: first, without a solution, the public will have increasingly less faith in us; second, the solution may be hard to find.

One solution might be a Federal PERISA, broadened to establish funding standards, monitoring of actuarial performance, and dis-enrollment penalties. A second might be similar to PERISA's set up by the states. A third might be direct intervention by the Academy or the Society upon each occurrence of public disagreements of importance. I do not know which, if any, of these is a practical solution.

One ethical-practical problem occasionally arising is what to do about actuarial assumptions established in advance by statute or by a retirement board. If an actuary cannot accept such assumptions, should he decline to perform a valuation, issue a qualified report, or perform two valuations, the second being his best estimate? The first of these alternatives means no work. The second is satisfactory to no one. And the third increases the cost of the valuation work without generating additional fees to cover the cost.

Some other practical problems are:

(1) How to persuade a government entity that funding should be increased substantially now, in order to avoid larger, unavoidable increases later.

(2) When to volunteer advice about plan changes when such advice has not been sought. I believe that even when an actuary is retained just to do actuarial calculations, he, as the most knowledgeable person available in plan design matters, should advise his client on all the possible adverse effects of proposed changes.

(3) Bidding for public actuarial jobs is expensive for consulting firms, although it is the most reasonable approach for selecting actuaries for public bodies. When a plan sponsor places its current actuary in jeopardy every year or two by soliciting bids from competitors, he needs to maintain very close contacts to protect himself.

(4) All of these problems, taken together, increase the costs of public retirement system actuarial work. In order to avoid losing money, a consultant must work efficiently, maintain good client relations and quote adequate fees.

JONATHAN SCHWARTZ: I think that it would be useful to recast some of Bob Kalman's remarks into actuarial terminology. He summarized his presentation by stating that although terminal funding should be abolished, the goal of full advance funding, as defined and mandated by ERISA, is not necessarily appropriate. This proposition can be restated as follows:

No contributory defined benefit plan should have a Quick Liability Ratio of less than 100 percent. In other words, the assets on hand should be at least sufficient to cover the sum of (1) the accumulated contributions of present active members and (2) the present value of future benefits to present retiree- (the retired life reserve). If a plan's QLR is less than 100 percent, then the assets on hand are less than would have been accumulated under terminal funding. It thus appears to be self evident that there would be no disagreement that a QLR of 100 percent would represent a floor funding level for public employee retirement plans.

Now that we have established that a funding goal for a public sector plan necessarily entails a QLR of over 100 percent, but need not entail having assets equal to the plan's accrued liability, the problem becomes to define such a goal. With respect to public employee pension plans, I would propose the following index, i.e., a plan's assets should be sufficient to cover both the "quick liability" and the accrued liability on account of all service rendered by active members who are eligible to retire. This standard, for the most part, is not terribly meaningful in the private sector, where normal retirement tends to be between 62 and 65, and where it is unusual for an employee to work past his normal retirement age. However, in the public sector, where retirement after 20 years of service regardless of age, or at age 55 with no early retirement reduction, is not uncommon, an analysis of a plan's active membership will show that a significant number continue to work beyond normal retirement. For example, as of June 30, 1978, over 20% of the active members of New York City's five retirement systems were eligible to retire.

As regards the question of the level of annual contribution that should be required for public employee plans, I do not subscribe to the theory that less rigorous standards are permissible in the public sector because public employer are immortal and enjoy unlimited taxing power. If anything, I would suggest that more rigorous standards should be required. For example, while the funding of a past service liability over a 40-year period may be appropriate in the context of a plan under which normal retirement is 62 or 65, I am not sure that it is appropriate in the context of an age 55 plan (not to mention a 20-year and out plan). As a further consideration, I would like to quote a statement that I made at the Annual Meeting in Boston in 1977:

> "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".

In this connection, I would like to point out that in fiscal year beginning July 1, 1979, New York City will be contributing to its retirement systems an amount that exceeds 28 percent of the payroll of their active members. This is an interesting phenomenon when juxtaposed with Bob's assertion that it would be onerous for Massachusetts to contribute 25 percent of its employees payroll

As regards present funding levels in the public sector, the plans, with respect to whose level of funding information is most readily available to me, are New York City's five retirement systems. Consequently, this portion of my discussion will concentrate heavily on these systems.

The assets of these systems, as of June 30, 1977, were about 48% of their accrued liabilities. On the face of it, based on a 1978 Congressional report on public employee retirement systems, this would place the New York City plans slightly below the 50th percentile of the largest state and local plans which have had recent actuarial valuations. However, since the liabilities of the City plans are based on "dynamic" rather than "static" actuarial assumptions, and since plans which have not had recent actuarial valuations tend to be poorly funded, I would conclude that the New York City plans rank well above the 50th percentile of all large state and local plans.

If the assets of the New York plans were exactly equal to the "quick liability", the accrued liabilities would have been about 44% funded as of June 30,

1977. Finally, it would have been necessary to fund about 63% of the total accrued liabilities in order to cover the accrued liabilities for active members eligible to retire. Such a ratio would have put a public plan close to the 70th percentile in the aforementioned Congressional study. It would then appear to follow, based on both the non-responsiveness of poorly funded plans and the variation in actuarial assumptions among the responding plans, that no more than 20% of large state and local plans meet the funding criterion which I proposed earlier.

Allen Arnold covered the practical problems of a public sector actuary so exhaustively that there really is not very much else left to be said on the matter. As far as I am concerned, the principal practical problem facing an actuary in the public sector is the difficulty in communicating a long-range concern to a group of decision makers for whom the long range is, by definition, no more than four years.

Another practical problem in New York State, as well as many other jurisdictions, is that actuarial assumptions, other than the rate of interest, must be adopted by a Board of Trustees which is evenly split between employer and employee representatives, whereas legislative action is required to change the rate of interest assumed for valuation purposes. In other words, any change in the package of assumptions which affects the interest rate necessarily entails simultaneous action of both a Board of Trustees and the State Legislature. Furthermore, since (1) New York City's plans are contributory, (2) historically, members' accounts have always been credited with interest at the valuation rate, and (3) it would be politically difficult to justify paying members 9% interest per annum on their accounts, I am more or less constrained to value liabilities implicitly, rather than explicitly.

MR. RUSSELL J. MUELLER: In the last few years the problems of public pension plans have come under increasing scrutiny by the public. A brief review of recent news stories reveals the concern of the public. Headlines read: "Your Pension: Will You Get A Fair Shake?" "Behind The Squeeze on Public Pension Plans," "Pension Nest Eggs We Can't Afford," and "Public Pensions A Time Bomb." A recent Newsweek Article summarized the issue as "The Pension Mess."

At the Federal level there is increasing recognition of the source of the problems with the Federal plans and the lack of a rational, coordinated pension policy.

The latest GAO report on the subject bluntly states -- "Federal retirement systems have developed on an independent, piecemeal basis, resulting in a patchwork of systems providing different benefits to various groups of employees. The Government has neither an overall retirement policy nor an established standard or method to assess the adequacy of retirement benefits. In addition, no uniform practices or principles exist for financing the retirement systems. Moreover, legislative oversight is diffused, in that different committees of the Congress have legislative jurisdiction over the various systems.

Fragmented congressional committee jurisdictions and responsibilities have probably contributed to the piecemeal evolution of the Federal retirement systems. For example, up to 10 committees in the House and 10 committees in the Senate could have legislative responsibilities for 12 of the systems. Furthermore, the administration of these 12 systems is fragmented among 16 different organizations."

GAO believes that an overall Federal retirement policy and a centralized management focus on retirement matters would help assure that the systems develop on a consistent and financially sound basis.

The GAO report merely echos the findings of the Pension Task Force which were presented in a Report on PERS last March.

As a result of the PTF report, legislation was introduced last year to bring the 68 federal plans under the reporting, auditing, and actuarial requirement of ERISA. That legislation is now public law (P.L. 95-595). When the annual reports under that law are filed for this fiscal year, it will be the first time that a full accounting of all federal plans will have been available to the American public. I assure you that report will make for lots of very interesting reading.

Hopefully the President's Commission on Pension Policy will address the other issues in the GAO report and lend its weight to a rational and permanent solution to the problems surrounding federal pension plans. The same might be said of state and local plans as well.

With the passage last year of the PERISA for federal plans, the Congress is no longer in the position of "do as I say, not as I do" regarding ERISA standards for state and local pension plans. The trend is obvious as displayed by the House and Senate action taken last year to extend ERISA--like reporting, disclosure, fiduciary, and funding standards to the pension plans of the District of Columbia. Unfortunately, President Carter unwisely vetoed that measure--but the House District Committee has already passed an identical bill in this Congress. The House and Senate may in this Congress give President Carter a second chance to redeem himself as being in favor of public pension plan reform.

The PTF Report issued last year documents the need for states and local pension plan reform.

Rather than for me to attempt to present all aspects of the public pension issue which are covered in the nearly 1,000 page Pension Task Force Report, I have drawn together some of the major findings under 10 points.

<u>Point Number 1</u>. The very nature of government, whatever the level, hinders the development of a rational, continuing pension policy. State Representative Dan Angel of Michigan summed it up this way -- "Right now we have what amounts to a porkbarrel and piecemeal approach to pension modification. We modify one system without regard for fiscal consequences and then other systems want the same. This takes place in a totally political atmosphere without any regard for how the bill will be paid, by whom, and when. There is a total absence of logical structure. Employees had better get concerned that there is enough cash on hand to meet retirement needs and taxpayers had better get concerned with these massive and increasing debt obligations. We simply cannot continue in this helter-skelter fashion." I might add that given the complex nature of public pension plans themselves, plus conflicting and confusing state statutes, constitutional provisions, and court interpretations, a great deal of legal uncertainty exists as to the rights of plan participants, the standards governing the conduct of plan officials, and the remedies available to aggrieved participants.

Point Number 2. It can be generally stated that the relative pension levels for most public employees rank in the Cadillac division when compared with the pensions for most private employees. A conservative estimate shows that at least one-half of the full-career state and local government employees retire on pension plus social security income equalling 100% or more of pre-retirement net income. Nearly all career public employees can expect their pension income to replace at least 50% of pre-retirement net income.

Point Number 3. In some plans the lack of clear cut pension policies and control has led to administrative laxity, favoritism, and abuse, especially in the granting of disability pensions. A county-run plan in one state was actually forced into receivership because of such abuse.

Point Number 4. In many cases plan disclosure to participants is inadequate or non-existent. In such cases plan participants and beneficiaries are unable to assess properly plan financial operations, are unappreciative of the true level of pension costs, and are unaware of conditions leading to benefit losses. For example, less than half of all public plans make a regular practice of distributing and updating plan descriptions of one form or another.

Point Number 5. In general, public pension plans do not operate within the customary financial and accounting procedures applicable to private pension plans. Nearly one-third of all state and local plans do not provide for annual audits. Some of the largest plans in the country are audited only every 4 or 5 years, and then they are audited by related government agencies rather than by external independent auditors.

Point Number 6. Throughout the universe of public pension plans there is a virtual absence of clear fiduciary guidelines. Even among the plans administered at the state level, 50% are not subject to general fiduciary standards either by statute or case law. The inevitable result has been excessive conflict-of-interest,and instances of imprudent actions and self-dealing.

Point Number 7. In the vast majority of public employee retirement systems, plan participants, plan sponsors and the general public are kept in the dark as to a realistic assessment of true pension costs. The high degree of pension cost blindness which pervades the PERS is due to the lack of actuarial valuations, the use of unrealistic actuarial assumptions and the general absence of actuarial standards. The unfunded liability for the federal pension plans is estimated to be between 243 and 425 billion dollars. Though these numbers are striking, it is the disparity between the highest and lowest estimate that should cause concern. In effect what we have is a $200 billion misunderstanding.

Point Number 8. The majority of all public plans are experiencing rising pension costs as a percentage of payroll due to the lack of actuarial funding practices. Approximately 17% of governmental plans continue to use the discredited pay-as-you-go financing approach to satisfy benefit obligations.

A GAO report soon to be released will undoubtedly show that some systems will have to double their present contribution level if they are to meet minimum levels of actuarial funding.

In addition, in many cases pension plan revenues lack stability and predictability due to the indeterminate amount of funds available from stipulated allocations of state insurance premium taxes, federal revenue sharing funds, or limited special tax levies.

Point Number 9. While there is no past evidence that public employees have suffered pension losses as a result of plan terminations, other risks do exist.

It appears that the greatest risk to public employees of having pension benefits reduced or other benefit features curtailed relates to governmental financial problems and the underfunding of public pension plans. Mismanagement, financing limitations, exceedingly high pension obligations, and financial emergencies have all contributed in the past to situations of pension plan insolvency or near-insolvency. As a result of these situations, some public employees have suffered temporary and, in a few cases, permanent benefit reductions. We have seen downward readjustment in pension formulas not only at the state and local level, but in the Federal Civil Service Retirement System and the Social Security System as well.

Point Number 10. We should all be aware by now that the Federal government has already been called upon to bail out New York City and, ultimately their pension funds, by relaxing the limited set of fiduciary standards that are applicable to public plans under the Internal Revenue Code.

At this time it may be worth repeating the sequence of points that I have made, taking note of their order.

First - we find government chaos and no well-defined public pension policy.

Second - we find a significant minority of employees having exceedingly generous pensions.

Third - we find administrative laxity and disability abuse.

Fourth - we find inadequate disclosure.

Fifth - we find inadequate auditing and accounting practices.

Sixth - we find inadequate fiduciary standards.

Seventh - we find inadequate actuarial standards.

Eighth - we find inadequate funding.

Ninth - and perhaps because of all of the above -- we find increasing evidence of benefit reductions, and

Tenth - we find the Federal Government being sought out for pension fund relief; because of the action taken last year the Federal government is now providing a form of insolvency insurance to the pension plans in New York.

Let there be no doubt about it, the Federal Government has a substantial interest in how the state and local plan funds are invested and how well they are funded. About $1 billion or approximately one-tenth of the employer contributions to state and local plans are attributable to federal grant monies. This percentage may double to 20% if federal revenue sharing monies are also taken into account. For example, a state law exists in Delaware requiring that all revenue sharing funds from the federal government be automatically placed in the state pension system. These funds plus employee contributions are the only two sources of plan funding.

A fair reading of the House Pension Task Force Report on Public Employee Retirement Systems should convince all but the rank skeptic of the need for immediate and responsible action on the part of state and local governments as well as the Federal Government.

The PERISA legislation that will soon be introduced by Congressmen Thompson and Erlenborn provides the needed first step in reforming public pensions. The bill addresses each of the ten points I discussed previously -- but in a flexible and workable manner.

PERISA

The purposes of the proposed Public Employee Retirement Income Security Act of 1979 are to protect the interests of public pension plans participants and beneficiaries and to minimize the possible adverse impact of the operations of such plans on Federal revenues and expenditures and the national securities markets:

1) by establishing minimum standards of fiduciary conduct for trustees, administrators, and other dealing with public pension plans;

2) by requiring the disclosure of plan provisions to participants and beneficiaries and the reporting of financial, actuarial, and other information;

3) by providing for appropriate remedies, sanctions, and ready access to Federal courts;

4) by clarifying the application of the Internal Revenue Code to public pension plans and extending the tax benefits of qualified plan status to such plans; and

5) by establishing an Employee Benefit Administration to effectuate a rational and coordinated regulatory system for private as well as public pensions.

The 1979 version of PERISA will be similar to that introduced in 1978. However, some modifications have developed as a result of the hearings held on the bill last year.

1) If a state passes legislation requiring reporting and disclosure standards at least as stringent as the federal minimum standards, then the state would be exempt from the federal regulations. States would have the freedom to provide more stringent requirements. Plans would still have to file with the states, and the annual reports would then be forwarded to the federal government.

2) The federal agency overseeing pension plans is the key to the passage of PERISA. The bill establishes a single Employee Benefit Administration to effectuate a rational, coordinated regulatory system for both public and private pension plans. PERISA will probably not be enacted unless the divided administration issue is addressed. It is possible that a PERISA/ERISA omnibus bill will be passed in 1980, if the problem of multiple administration is solved.

3) PERISA does not directly require that the states fund. It does establish an Advisory Council which is mandated to establish voluntary funding standards. The Council is to meet with actuaries, and other interested parties to develop these standards. This will provide the actuarial profession with a unique opportunity to assist the council in order to formulate rational funding guidelines.

4) The question of a uniform, understandable terminology will be addressed. Actuaries can uniquely assist in the resolution of this concern before the enactment of PERISA.

In the past actuaries have expressed extremely divergent opinions about the necessary level of funding, from pay-as-you-go to the aggregate level, for public plans. Several observations need to be made. First, usually little or no analysis of the resources of the plan sponsor is made by the actuaries when funding recommendations are developed. In analyzing the funding levels for public pension plans, actuaries and others must be cognizant of the limitations of employer resources and the prospect of future government operations. For example, in a number of jurisdictions it may be unrealistic to assume that public employment will continually increase. Also, the current preoccupation of maintaining contributions as a level percentage of payroll must be reassessed in light of current and prospective economic conditions. Employer contributions to public pension plans must receive priority comparable to that of wages and must be made, if benefit promises are to be kept.

Conclusion

President Carter has correctly pointed out the numerous inadequacies and inequities in our national Retirement Income Security System (RISS). The House Pension Task Force study and many other studies fully document these conditions as they relate to the PERS segment of RISS. In this uncertain world it is certain that the inadequacies and inequities of benefits and costs as well as employee protections fall quite unevenly within the PERS and the RISS as a whole.

ERISA provides employees in private pension plans with certain protections against pension benefit reductions, forfeitures, and default. With some exceptions public employees do not enjoy similar guarantees. At the same time we find that the high costs resulting from deficiencies in past practices are threatening the stability of the funds in many sections of the PERS. It is time to institute a "prevent defense." To prevent public pension problems from growing and to enhance public employee benefit security certain steps should be taken now.

First, the air should be cleared regarding the universal coverage of public employees under social security and the permitted degree of "integration" of public and private pension plans with social security. Secondly, all public plans should be required to meet ERISA-like actuarial, accounting, reporting, disclosure, and fiduciary standards. Finally, the tax status of public systems should be clarified. Ideally, all these actions should be carried out under the jurisdiction of a single federal agency having responsibility for all pension matters. These measures are necessary. Public employees, public employers, and taxpayers should all demand no less.

DISCUSSION:

MR. LEONARD J. BARDSLEY: I am Manager of Employee Benefits Section for the Du Pont Company and I am a public trustee for State Employees, Teachers, State Police and Judicial Pension Plans in the State of Delaware, and Chairman of the Investment Committee for those plans. I would like to comment on several things that have been said about Delaware Public Employee Retirement Systems. First, in Delaware about 90% of all public employees are covered by pension plans at the state level. Of these individuals, 98% are in a single plan and that plan is on an actuarially sound basis, entry age normal funding method, 40-year amortization of liabilities, and explicit actuarial assumptions. Without speaking to the source of the funds, as a trustee I can assure you that the plan is funded and that the funds are appropriately invested.

I have a number of additional comments principally on the presentations of Mr. Kalman and Mr. Schwartz. Mr. Kalman stated in his presentation that public sector plans are subject to unique considerations not present in the private sector. Those he cited were budgetary constraints and a declining tax base. I can assure Mr. Kalman from my own experience in the private sector that budgetary constraints are not unique to public employee plans. While private plans may not suffer from a declining tax base, there are rather close analogs as the Studebaker debacle, which created so many problems, will attest. It is precisely the public plan with a declining tax base which must fund its obligations -- otherwise its pension promises risk not being met.

Just one further point on this issue. A political entity which starves its pension plan is in reality relying on a very expensive form of debt. It would almost invariably be cheaper to borrow money and fund the plan. This comes about because most political entities are able to issue tax exempt obligations, whereas their pension funds, if they are sensibly managed, invest in taxable obligations at higher yields.

We have a live example of this in Delaware, where a few years ago, the state government issued promissory notes to the pension trust. The trustees were able to persuade the government to take back these notes, to obtain their financing elsewhere, and give the pension trust real money. The trustees guaranteed the state government that they would cover the interest on the borrowings needed to pay the pension trust and turn over a profit in the bargain and this has been the case. If any of you are interested in the details, I would be happy to talk to you about it.

I have only one comment on Mr. Schwartz's presentation. He stated that nothing an actuary does can influence the cost of the plan and I most emphatically disagree. If we as actuaries serve on boards of this type, educate legislators and politicians, plead, persuade, explain and cajole regarding the necessity of funding, we will have a very great effect on the future direction of these plans.

MR. KALMAN: From my experience, the budgetary constraints seem to be more apparent, pervasive, and universal for the public sector, especially in local government, than for the private sector. Certainly, budgetary constraints do limit private employers with respect to meeting funding obligations. Concern must exist for the source of monies for funding pension plans since it is quite possible that some of these sources will not exist in future years.

MR. THOMAS D. LEVY: Funding for the public plans has so far been considered mainly to protect the employee. Two other criteria seem even more important to me, intergenerational equity and recognizing the cost of plan improvements. In Massachusetts the pay-as-you-go approach and the lack of funding for future benefits forced reduction in the cost of living increases. Finally, what should be the role of public employees unions in implementing funding for pension plans?

MR. KALMAN: Greater representation of public employees on Boards of Trustees and intelligent, responsible employee representatives could improve the current problematic situation where 1) usually the public employee representative is the minority representative who does not have the voice to promote changes and 2) political concerns greatly control the future state and local plans.

MR. CONRAD M. SIEGEL: Bob, what means are you using to explain rationalization of benefits, that is, a reduction in the level of benefits when excessive, to the local level?

MR. KALMAN: We talk to our membership about what constitutes an adequate benefit and we define adequacy in terms of what portion of income is replaced by Social Security and the private plan. We discuss rational plan design not to emphasize benefit reduction but to establish what private plan benefit is necessary in conjunction with Social Security to be adequate and also what is needed to provide some benefit protection against inflation.

MR. DAVID ROSENBERG: Discussion seems to be focused on increasing the level of funding for benefits. However, should not the levels of benefits be considered before the funding is increased?

MR. KALMAN: It is possible that a 30 or 35-year employee may receive a combined benefit from Social Security and his public plan which exceeds 100% of disposable income at retirement. The determination of what is excessive is difficult; consideration of the erosion of inflation is necessary. Secondly, public employees contribute between 5 to 8 percent to the plans. Thirdly, if the additional plans, such as profit-sharing plans, available in the private sector were considered when determining the income replaced at retirement, it is possible that the public plan benefits would not appear excessive.

MR. ROBERTSON: It is perhaps somewhat artificial to separate the twin questions of (1) type and level of benefits, and (2) funding. Obviously, one way to alleviate funding problems is to curtail any benefits which may be considered excessive. Frequently a better job can be done in coordinating public plan benefits with Social Security benefits, the net result of which may be a decrease in public benefits and an improved funding status of the public benefits which remain. It is even possible that a public system, not now participating in Social Security, may elect to participate in order to reduce the benefits which are provided through the public system. Depending upon the circumstances, this may or may not reduce the total cost of the combined benefit systems.

MR. JAMES B. GARDINER: I wish to comment concerning the Pension Task Force Report and New York pension plans. The Report was rather pessimistic about the future of state and municipal plans; however, New York is not mentioned in the body of the Report. New York plans covering all other public employees outside of New York City are funded on the basis, roughly, of 100% of the retired lives and 60% of the remaining actives. This basis, I think, shows a higher level of funding than most plans. The state legislature in the early 1970's 1) required that every pension bill submitted have a fiscal note attached explaining the associated annual estimated cost and 2) gave authority to the state insurance department to establish standards for the public pension plans in six areas. The state realizes the need for standards and intends to establish such in the future.

MR. MUELLER: The Report did uncover well-funded plans as well as poorly funded ones. Today, the well funded plans are under tremendous pressure to go unfunded. The actuarial profession, when recommending voluntary minimum standards for the funded plans, must not disregard the needs of plans which are already well funded. Future minimum standards should not negatively impact those plans currently funded on an adequate, sound basis.

MR. ARNOLD: To establish a sound financial basis for the pension plans, I think it is acceptable to phase into the sound basis gradually. Even though the total normal cost and amortization is not made immediately, establishment of a definite plan to achieve a sound financial basis and a time allowance to permit budgeting to match actuarial requirements is necessary.

MR. ROBERTSON: I hope that our panel today has given you some new information about public employee retirement systems. But most of all, I hope that the panel has created more of an awareness of the problems of public systems, and of the tremendous responsibilities which we have as actuaries--not only as employee benefit consultants but also as citizens with unique background and experience which should enable us to play an important role in the development of rational public employee benefit systems.