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PUBLIC PENSION PLANS

Moderator:	ROBERT STEVEN DEZUBE
Panelists:	WILLIAM V. HOGAN
	RICK A. ROEDER
Recorder:	ROBERT STEVEN DEZUBE

- Nondiscrimination issues
- Plan design issues
- Funding
- Political considerations
- Public plans as a source of budget revenue
- Other current topics

MR. ROBERT STEVEN DEZUBE: We're going to attempt to cover cost-of-living increases, funding issues, nondiscrimination issues, what is happening in California between the legislature and the governor, Section 415, and the Betts legislation. I'm a consulting actuary in the Washington, D.C. office of Milliman & Robertson, Inc. Joining me are Bill Hogan, a consulting actuary with our Milwaukee office, and Rick Roeder, a consulting actuary with Gabriel, Roeder, & Smith in their San Diego office.

More specifically, Rick manages Gabriel, Roeder, Smith & Company's activities on the West Coast. He has 16 years of previous experience in the pension field consulting to some of the largest pension plans in the country. He has also had a wide variety of experience with corporate programs of all sizes. Rick is a Fellow of the Society, a member of the Academy and an Enrolled Actuary. More interestingly, Rick has also passed all 10 examinations given by the American Institute of Certified Public Accountants. Rick did his undergraduate and graduate work at the University of Michigan.

Bill has 14 years of experience in this field, seven with an insurance company, the rest with two consulting firms. Bill has been with Milliman & Robertson since 1988. While his specialty is defined-benefit and defined-contribution work, he also is involved in other types of employee benefit work. Bill also is a Fellow of the Society, a member of the Academy, and an Enrolled Actuary.

We hope our opening discussion will cover most of the topics that you expected. Our goal here is to get discussions going on any subjects that may interest you besides the ones we are planning to cover here.

MR. RICK A. ROEDER: I don't want to spend my time talking about anything of a very technical nature; instead I'll discuss the political environment that governmental plans are increasingly finding themselves subject to. I've been reasonably closely involved in several capacities with what's been going on in the state of California in the last year or year-and-a-half. I think this is a case where what happens in California is going to have a big impact on what happens in the rest of the country, because of the high visibility of the state, and the fact that the Public Employees Retirement System (PERS) fund is now rocketing toward $60 billion. That alone commands a lot of attention.

One of the traditional roles of a retirement board is that they appoint the actuary to the board. One of the things that the Wilson Bill last June did was to transfer the responsibility for selection of the actuary from the retirement board to the governor's office. Wilson is Pete Wilson, the Republican governor, and former mayor of San Diego. They solicited bids from various firms. I got some pressure from some of my associates in some of our eastern offices. They thought that this would be such a controversial thing that we elected not to bid on it. I was later told by someone in faraway San Antonio, Texas (where we were involved in a bid situation last November) that if we had bid on California, that we wouldn't have been considered to do their work. So it seems to have kind of a potentially far-flung effect in terms of what's going to be happening around the country.

I think that a little bit of background before last June's legislative package is probably in order. There had been some animosity between the retirement board and the administration before last June. California has been having some increasingly hard times the last year-and-a-half. In light of that, in late 1990, the retirement board voted for state employees to go from high three-year compensation to high one-year compensation. It raised a lot of issues in terms of the timing. Also, there were a number of people who felt that at least close to half a dozen members who voted, should have abstained, because they in effect were increasing their own benefits; conflict of interest issues were raised.

At the same time there was a reasonably influential lobbying group called CalTax, which is funded largely by corporations in California, that was basically expressing its viewpoints that public pension plans were much more liberal than their private sector counterparts, and because of the state's increasing economic difficulties, the public plans should be put more in line with private sector benefits. And you can imagine how well that went over with a lot of the employee labor groups.

This is some of the background that preceded what happened last June. There definitely were a lot of political considerations above and beyond the mere nuances of funding of the benefits. The thing that I think raised the most ire and the most protest was that in California, there is a cost-of-living adjustment (COLA) for state employees that's capped at 2% a year. You have a little more flexibility if you're one of the 1,200 funding agencies that also contracts for benefits through PERS. You have a choice of contracting for a COLA capped at either 2%, 3%, 4%, or 5% a year, with the vast majority going for the 2% COLA cap.

As a result, not so much because of inflation that's occurred since 1983, but because of inflation that was almost at double digit levels for several years in the late 1970s and early 1980s, you have some long-time retirees who have had the original purchasing power value of the annuity they originally were receiving eroded. And so, roughly 12 years ago, a bill was passed where not only would you be entitled to a 2% COLA increase each year (that was the cap and we certainly haven't had many years in the last 12 or 13 where the COLA has been under two, maybe one, if that), but on top of that there would be two types of extraordinary COLA adjustments to preserve purchasing power that would largely affect people who have been retired for some period of time, maybe 15 or 20 years. These are the people whose purchasing power has been eroded due, in no small measure, to those high inflationary times of the late 1970s and early 1980s.

There were two separate programs. The first program would try to preserve 75% of the purchasing power of your retirement benefit at the time of retirement, while the second program would get you up to 80%. The funding mechanism was that if the earnings were above the actuarial interest rate for the state plan, (which in recent years has been 8.5% for PERS), the excess earnings would go to fund these extraordinary COLA increases.

Because of the high rates of return available in the financial markets from 1983-90, there was a fair amount of money that had been set aside in these funds above and beyond what was needed to pay benefits. It was about $1.8 billion at the point in time that the Wilson package passed last June. Basically, the Wilson Bill said, "We're going to use that $1.8 billion not as a slush fund anymore for these supplemental COLA payments, but instead toward the next cash contribution that the system was going to be requiring from its member entities."

Starting last November 1, those extraordinary COLA checks got slashed. You can imagine some of the political ramifications when people in their late 70s and 80s started calling up the PERS office. And you can imagine some of the articles that followed. Its been a real controversial situation.

Basically outside of the "perceived political cost" to Pete Wilson, there also have been some court challenges and in the last week-and-a-half, the judge has ruled that what happened was not unconstitutional. And the reason the judge said it wasn't unconstitutional is that there is a replacement plan in the Wilson package that provides some additional supplemental increases. It's not going to be funded from excess actuarial earnings, but it is going to be funded through excess earnings on employee contributions. So you're talking about excess earnings on kind of a smaller base than what existed before.

MR. LAWRENCE F. WILSON: Do the employee contributions get the typical 3.5-4% interest?

MR. ROEDER: I can't recall right now what percentage they are getting. I don't think it's the actuarial interest rate. I think it's something less that than, so there is a real bona fide chance that some excess earnings can occur from that. The 75% purchasing power guarantee isn't absolute. It is an absolute as long as general inflation does not rise above 5% a year. But if we have a recurrence of the situation that existed in 1979-81, there are no absolute guarantees on the purchasing power, it could actually be somewhat eroded in that case. That's a good question.

This raises an interesting issue. I'd be interested in input from the audience. I know in California in the past 10 years that postretirement health benefits, as well as other benefit increases that can be funded out of these "excess earnings" that are above the actuarial interest rate, have been fairly popular. Is that also a fairly common practice in other parts of the country or is that more a California-type of thing along with hot tubs and surfboards? That has happened a lot in California. And it's kind of a seductive way to get extra benefits. It has the actuary a lot of times sounding like the lonely voice in the audience saying, "Well, what about those times that you have some bad years and that thing about long-run probability and actuarial gains and losses over long periods of time and all that." And the eyes have glazed over and usually after the first or second sentence, you're kind of fighting a lonely battle in trying to raise that consciousness.

MR. JARMON WELCH: I'd like to suggest that you should anticipate the additional earnings, for example, by raising the normal 8% net investment yield assumption at retirement to 9% or 9.5% and then at the same time make the ad hoc COLAs a permanent feature of the plan when are you valuing the liabilities. The Bankers Trust study of 1980 showed that of 454 major public pension plans in America, about a third of them use ad hoc COLAs. That is, every two or three years they may give an increase, but they do not value those COLAs as part of the liabilities of the plans. They wait until these extra earnings emerge to value them. In my judgment and I imagine in the judgment of many in the room, a preferred approach is to capitalize those ad hoc COLAs by making them a permanent part of the plan and then to anticipate close to the average expected net investment yield. Obviously 8%, even though we usually say its our best estimate, is not our expected value. The expected value is typically higher, 9-9.5% for the investment yield. So does what I'm saying make sense?

MR. ROEDER: Yeah. I just have one comment. I know that the various accounting standards (this pertains to expensing and not funding, but maybe there's an analogy that can be drawn), indicate that if every two or three years there were fairly predictable, periodic, ad hoc increases, they should be treated as a structured benefit just as if they were in the statute for purposes of expensing them.

MR. WELCH: But I'll bet the majority of folks don't do that. If you have a public pension paying client who has typically given ad hoc cost-of-living increases, is anyone anticipating that in their valuation? I'm not the only one?

MR. ROEDER: Sometimes the cynical part of me wonders if those states having a budget crunch would love for you to bring that issue up. But you're absolutely right. I would agree with you, from both a funding and an expensing standpoint; it is more prudent to systematically recognize that.

I'm just going to make a couple of other relatively brief comments and then turn it over to Bill. Robert had asked me if I could make a few brief comments about what's going on with the Government Accounting Standards Board (GASB). I know that both representatives of Milliman & Robertson and our company are having fairly regular contact with Penny Wardlaw and the Government Accounting Standards Board. And basically not much is going on. After their Draconian preliminary views were issued, and in my opinion, judiciously scrapped in favor of a much more flexible exposure draft in the spring 1990, the board has been soliciting comments on a very leisurely basis. It's not a high priority right now, and it wouldn't surprise or shock me if it is not another 18-24 months until we get a final statement. It's just kind of a back-burner item right now.

I can tell you about a couple of things that I think will either change or may be a little more flexible than the exposure draft that came out in 1990. The first thing that I think will probably be subject to change is not an expensing consideration as much as a disclosure on the financial statement in that you had to disclose whether there was a different real rate of return outside the 1.5-4% corridor. And by real rate of return, I mean if you have an 8% investment rate of return and a 5% salary increase assumption in a final pay plan, your real rate of return is not the 3% difference, but it's 3% plus whatever you've imputed as the merit and longevity component of the 5% salary increase. I have been surprised that our definition of real rate of return hasn't been really consistent with that of a couple of actuaries in other good companies. So anyway, even though that supposedly was going to be a disclosure item, I think that there's probably going to be a little more flexibility in the final statement.

There was also an "or" in that, too. They were going to say that if your interest rate was more than 1% different from the interest rate of the 100 largest statewide PERS, that you were going to have to disclose that. I think that's probably going to be a goner in the final statement. I think that they will just get rid of that.

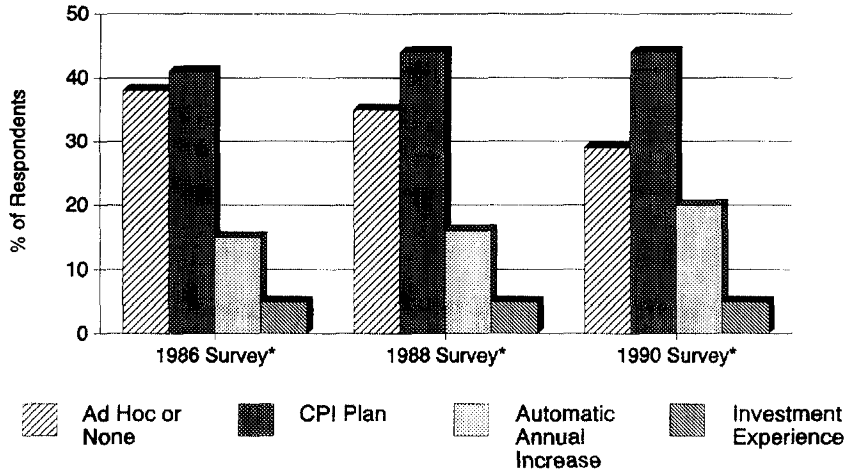
For those of you who are exposure draft buffs, this is going to bore you. The exposure draft said that for an existing plan at the date of transition (we don't know what the date of transition is going to be) you couldn't have an amortization period on a closed basis that was longer than 40 years. For new plans coming in after transition, it said you couldn't have more than a 30-year amortization. That's basically where it was at. But there's going to be enough flexibility that if you use a rolling amortization period, where you are never going to theoretically totally fund your plan, but instead each year you might, for example, amortize over 15 years and keep doing that 15-year amortization into perpetuity, there would be enough flexibility to make that an okay deal.

One of the other things for which we're hoping to get some flexibility is that there are a number of states where their contribution rates are written into the statute and they don't have the flexibility to change their rate each and every year. So what happens as a practical matter is that the actuarial valuation gets done, the normal cost gets calculated, and then whatever the residual difference is between the normal cost and the statutorily required cost is your contribution towards unfunded liabilities. That results in a fluctuating amortization period from year to year. We're hoping that there will be enough flexibility in the final statement that as long as you can show that it's better than 30-year amortization period or somehow show that it's being responsibly funded, a fluctuating amortization period will be okay.

MR. WILLIAM V. HOGAN: I wanted to touch base on a couple of items here that were of interest to me and I'm kind of hoping to generate some audience discussion to get some other thoughts and views on some of these things.

Basically, the first area I wanted to get into was the COLA situation. I was very interested in the comments that have come up already on the COLAs. Chart 1 summarizes information from three surveys performed by the State of Wisconsin. It does a survey every two years and puts together a bunch of information which is really useful to kind of sit down with and try to assimilate to. Basically, here are the cost-of-living adjustments that are being offered by the various state systems. I've categorized the four various types of increases that the systems seem to provide. Obviously they're all different and modified in their own respect, but there are basically four variations that GASB has classified in their discussion draft, so that's the way I followed it.

CHART 1
Cost of Living Adjustments



* 1990 Survey prepared by State of Wisconsin. 85 respondents.

And as you can see, the ad hoc category (first bar) is a significant part of the COLA increases that state systems currently use. A CPI-type plan (second bar) is the most prevalent and the ad hoc has started to drop down. States are starting to use more of a formalized cost-of-living arrangement and I guess I would expect that to probably continue into the future, especially if the GASB starts requiring recognition of COLAs.

The thing that's interesting, though, is the comment that the gentleman made about what systems are doing in terms of recognizing the costs of these COLAs when they enact them. The GASB has made a distinction between permanent-type ad hoc adjustments and temporary adjustments and its feeling is that for any adjustments that are made on a permanent basis, the full cost of that adjustment should be recognized in the future. And from that standpoint, I guess I would be inclined to think that the funding, if that were ever put into the accounting aspect of it, would be pretty hard pressed not to do the same.

MR. WELCH: I consult for 17 public retirement systems and I've asked each one that has ad hoc COLAs and that will not formalize the COLA (and of course there are good reasons not to, such as the neverending nature of it), to put the ad hoc paragraph in the plan document, ordinance, or act. It should say that the Board of Trustees, or whoever will periodically review the cost-of-living increases in light of how they might relate it to net investment yields, other assumptions (which is a difficult way to do it) or to not increasing their contribution rate. But if you put that paragraph into that act, the actuary has an actual paragraph to refer to and perhaps can fund for it in his valuation. In the State of Florida, where they have their own little version of ERISA, the state department that reviews the local actuaries requires that you take that paragraph and actually fund for the trend. So that's an indirect way, actually, to have something of value to relate to.

MR. HOGAN: I agree. I think that's a good approach and you have almost informally created an automatic COLA provision that you could value. I'll make another comment on the COLAs. From my perspective, wearing two hats, I do a fair amount of private plan work, as I'm sure a lot of you do, and in terms of keeping that straight with the public plan work, it's kind of hard sometimes to see the forest for the trees. On the one side, you have to put them in and value them, I mean, you'd be hard-pressed to ignore that. On the other side, you've got so much political consideration to keep in mind with the public plans. And it is difficult to keep that in perspective.

MR. DOUGLAS L. THOMPSON: I have very little experience with public plans. I'm not an actuary on any public plan, so I'm going to raise my question from a somewhat naive point of view perhaps. When I think about cost-of-living increase provisions in private pension plans, from a Financial Accounting Standard 87 standpoint, one of the key criteria is whether the history of the ad hoc increases creates an expectation on the part of the employees as to whether there would be additional increases in the future. And so, if you put a provision in a document that has the implication that the increases are going to take place, it would then create the atmosphere for wanting to include it in the valuation, but it also may be creating a legal commitment. If you create the expectation, it's going to be harder to take out, and then they're no longer truly ad hoc increases. So I'd like to hear some comments about the issue of putting ad hoc increases in the document and the legal requirements it would create in the public plan.

MR. HOGAN: In response to that, I think that's a very good point and one of the big issues with public plans is that once you do put in benefit provisions, they have an impairment of contract-type issue in that you can't take that away, even prospectively, from existing employees. That's part of their employment contract. And so, from that standpoint, I think you're right. You've got a big legal issue as to what you have to provide. But if it is ad hoc and if it's worded right, I think the amount still is going to be subject to whatever criteria is being used to provide it. I think the key word there is "expectation."

FROM THE FLOOR: It's well-established that legally you can cap future salary changes in a public plan. You can't go so easy and undo past accrued benefits, but you don't have to have the salary increases in the future added to the current accrued benefits. This is what the ad hoc provision of the plan does; it's an additive future benefit. It's well-established that you can stop additive future benefits in any documents unless you have some kind of unusual document. That happens lots of times with cutbacks, retrenchments, and changes in plans.

MR. ROEDER: One of our large clients in southern California currently has an ad hoc issue. It doesn't have to do with the COLA, but I think its still relevant in terms of the ad hoc nature of the comment you're making. It has to do with cutting back postretirement health benefits that previously had been funded on an ad hoc basis. I'm not a lawyer and I can't presuppose who will win, but I offer one observation: whenever it goes to court, there's no sure thing and there's a lot of expense involved. And right now this client's retiree group is spending a fair amount of money to somehow see if they can maintain its benefits. So it may be the type of thing that even if you're right, there are issues to be formalized: there may be a lot of added cost, and potential problems with your constituent employee groups may result.

MR. BRIAN B. MURPHY: I just wanted to make a few comments on valuing these COLAs. I work for a number of public clients and some of them have had a provision that would say they would give a COLA of a certain percentage, possibly tagged to the CPI. It would not be valued prospectively, and that liability for the increases already given would not be included in the actuarial valuation as of any given date. You would just simply ignore it as a separate side fund from which benefits would be paid. I think that was what was being discussed earlier. When I first heard the discussion I thought, "No, no. Nobody does that." And I thought, "Oh, yeah, that's a good possibility for stabilization funding of this one thing and things like that." I've worked on two plans that have had that and both of those plans recently got rid of it via a change of actuarial assumptions. In other words, the benefits from the previously given COLA, that had been ignored in the valuation, were brought into the valuation at no cost by raising the interest rate.

The second comment I wanted to make related to valuing the COLAs that haven't happened yet. We've been wondering if you see a consistent pattern that every two or three years you give a 6% or 7% COLA, should you include this in the valuation? And there has been talk about various expensing requirements, possibly in connection with GASB. And it seems to me that we're in a very politically charged atmosphere in the public domain. If, as the actuary of a public, statewide plan, I were to come in and say, "Well, okay, Governor So-and-So, I've noticed that you've given these COLAs every year for the last several years, so I would include them in my valuation." I think the next actuary would possibly find a way not to do that.

Now if in the context of the plan document you had something written in that says the Board of Trustees will review the benefits every so many years and will make a decision based upon funding available at the time whether or not an ad hoc COLA should be given, I might view it a little bit differently. I might have some temptation to include it in the valuation. What would happen if I included it in a valuation and one or two years later a bill included it as a law? It would stop being an ad hoc COLA. The Board of Trustees would come back and they would say, "Well, okay, what would the cost be of bringing us up to 50% of CPI or something?" And I'd say, "Well, it's already in the valuation there." So the effect on the contribution rate would be zip. How could I say it's a no-cost item, yet it's in my valuation? So it increases the employer contribution and I'd be in a difficult position and it would be my guess that it would eventually become simply part of the law and it would stop being ad hoc.

MR. WELCH: I'd like to suggest with all due respect to the panelists and to this gentleman that as actuaries, like investment advisors, we tend to have a mirror where we can look at something one way or look at it quite the opposite way and be equally as convincing. And if we look at the way we value public pension plans or value all pension plans, we find that our methodology tends, in many cases, to produce excesses. It produces excesses because in your key assumption, like the net investment yield assumption, we don't use our expected value. An expected value, as you know, is a mean and is an average. It's what would be the midpoint on a bell curve. But we don't want to tell our clients half the time that they've had losses. We'd rather it be 10% or 15% of the time.

So we use a rate that is not our expected value and if we think that an 8% net investment yield is our expected value, I'd like to suggest that we don't understand how to calculate net expected investment yields. A typical portfolio might be 60% equity, which earns 10-12% historically, as a number of studies have shown, and 30% fixed income. We're talking about 5, 10, 15 years, or longer high-quality maturities which might earn 1.5% more than the rate of inflation or 7%. We're also talking about cash equivalents, which might earn a little more. So when you put that whole pot together, you get an expected net investment yield between 9 and 10%, depending upon the emphasis in the stock area, the percent in equities emphasis, and the emphasis in which you go to low-caps, mid-caps or high-cap stocks. I maintain our expected value in every pension portfolio is between 9 and 10% interest.

In our funding, what we typically do is use a low rate to be safe, or we don't understand investment theory and we really think that 7%, 8%, 6%, 4%, or whatever we used in the last 15 years was the proper rate to use. So you can present to a client that you have a margin, you have a cushion, you have a big pad in your assumptions. And you offset that by saying, "But we had hidden liabilities." There are these hidden liabilities around, whether they're salary increases greater than what we expected, whether they're increases in the minimum benefits for plans, or whether they're increases that we're talking about here, the ad hoc COLA.

So we have these extra earnings we haven't recognized. We have these extra liabilities we haven't recognized. And the last 10 or 15 years has brought us from being in the dark times to where we go to more realistic assumptions. We need to take the final step and use our actual expected values, disclose them as such, and use the liabilities that emerge and disclose them as such. If this prompts action on the part of the employer, when he understands his situation better in terms of permanentizing, so be it. We've done our job.

MR. ROEDER: First of all, I'd like to make the point that in terms of our firm, and I suspect it's probably true of some other firms also, we have a very definitive policy in setting assumptions for public employee retirement systems. Basically we take a two-tier approach. Most of the assumptions that we think are relatively easily predictable, whether they be death, disability, or rates of employee turnover, we also think are the actuary's domain and the actuary should have principle responsibility for setting those assumptions.

Because of the unpredictable nature of inflation, we think that with respect to economic assumptions in the area of real rates of return, salary increases, and investment assumptions, we don't have any special province in terms of figuring out what's going to be happening 10 or 15 years from now. You might be right that we could be earning 9% or 10%, 15 or 20 years from now, but I also remember that when I was teaching in graduate school, the book I used for a compound interest class had all its examples of interest using between 2-2.5%. And frankly the bottom has dropped out of the interest rates in terms of money markets in the last 18 months and I think that the only thing that is consistent and what we can know for sure is that there's been a lot of fluctuation in the last 20 years.

So we endeavor to jointly set the interest rates with the retirement board. And there's not necessarily a proactive bias in those retirement boards toward having that cushion to which you refer. The boards tend to be split pretty equally between the employee representatives and people who are appointed by "management" or city council or however you want to define that. We view ourselves as partners in setting the assumptions for large systems and we think that that's the appropriate way to go. We don't want to unilaterally do it ourselves, because we don't know what's going to be happening, and because we think that it should be done as a partnership.

MR. HOGAN: In certain situations, especially the ones that I'm currently involved in, we don't really have the leeway to change that. In the particular situation I'm thinking of, the investment return and the salary increase assumptions to be used for the valuation of the plans are set out in the code that the legislature adopts. And so with respect to that, we would have input, but we couldn't just decide based on our own feeling of reasonableness to go in and change that without going through the debate with the legislature and its committees and obtaining its approval to change those assumptions.

And I agree with you. In the current environment, 9% or 10% seems to be a very reasonable assumption as to what those large funds are going to earn. I don't think that all states have historically allowed their state boards to invest in those types of investments until the last 10, 15 or 20 years. Before that, by statute, they were very conservative in what they could invest in. So I think the history has been that the rates were low and now they're starting to trend upward. In retrospect, we actuaries aren't that quick to adjust to the changing environment because we want to make sure that in fact that is the way things are going. But your comment is very valid. I think right now those returns are easily being met by most large systems.

MR. MURPHY: This is my final comment. One of the clients I work for has a very large state plan with many billions in assets. And their rate of return for the end of 1990 was absolute zero based on market value. So while many of us are getting 9% or 10%, there are times when others aren't.

MR. ROEDER: No matter what our stress was as actuaries, it could have been worse. We could have been the money managers for that plan.

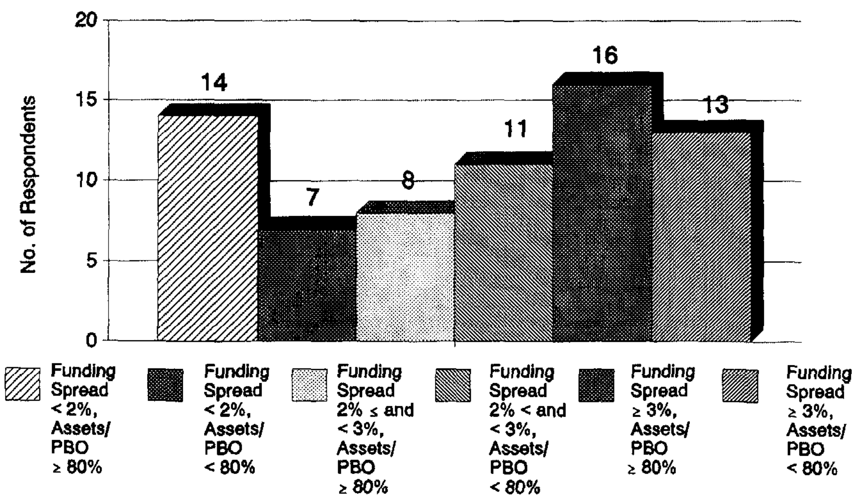
MR. HOGAN: I took what information I had available from the study we discussed to do some kind of measure of fund soundness (Chart 2). I'm not sure I would have necessarily used the ratio of assets to projected benefit obligation (PBO), but that's all I had available from that study. I kind of categorized six different areas of where plans fell into with the low end of the spread being funds that were using a spread of less than 2% and their funding ratio was up above 80% on a PBO basis versus the bottom end of the funding spectrum, which was funds using a greater than 3% spread and their ratio as being less than 80%. I kind of hoped that when I put it together, I'd probably get maybe a little bit of a bell-shaped curve. I got just the opposite. So it's kind of interesting.

Once again, I'm sure each of the funds has their own historical perspective as to why they've developed the way they have and it's not a comment necessarily on what people should be doing or what is being done, but I thought it presented some interesting insight into some other funding perspectives.

In addition, it kind of leads to the current environment where inflation is down and returns, at least on a lot of the shorter-term investments, are also down. The pressures that are out there in the current recessionary environment are to try to continue to make benefit improvements to keep the public employees happy, but at the same time not raise the cost. After costs come in we hear, "Well, we'd like to change benefits, but in addition, we think the salaries aren't going to be going up as high in the future, so what does it look like if we change the salary and we improve benefits?" Those types of requests are starting to flow in. I don't know what other people are seeing, but when you start making your policy on what benefits you're going to provide based upon the magical assumptions you're going to use in terms of producing your costs with respect to those benefits, those kinds of things scare me a little bit. Does anybody have any comments with respect to what they're seeing? Am I just running into isolated incidences? I'm sure I'm not.

I didn't put it into Chart 2, but most systems use entry-age normal funding, which I think most people agree is a very sound and safe method. Some other systems are using projected unit credit which is also a pretty good system for funding, but, if you're talking about being conservative and building assets, it's maybe not quite as sound depending on your population as entry-age normal. Projected unit credit may become more popular if GASB gets into the act and starts requiring states to use that as their basis for expensing.

CHART 2
Survey of Funding Levels



Note: Full information not available from 16 respondents in the 1990 Survey prepared by State of Wisconsin.

Rick made mention of the Cal PERS situation and I think there's a lot more of that happening, too. Funds are looking at places to get to the money and with the funding level, depending on where you're at, you may have some real concerns about what's going on. As the actuary, you don't always get asked what should be done;

you get told, "Well, this is what we're doing and what will result?" And so it's kind of hard sometimes to have some input on what's going into some of these decision-making processes.

I have another comment related to the funding that leads me into the next area. It has to do with the actuary's role in terms of funding. Our responsibility, on the private side once again, is very clear. But on the public side, what are the chances of the federal government coming in and trying to mandate certain funding requirements and actually taking a more proactive role than they have in the past, especially if some funds really start having some difficulty? Right now there are no forms that you have to file or sign and send to the government. It may not necessarily stay that way. I mean, what if you have to start signing and telling the government that this fund is okay or this is happening or this fund is doing something; where does that put the actuary? It's a problem because you are not talking to an employer, where you might talk to a committee or a handful of people that are running a company. Instead, you're dealing with a legislature that has a lot of political considerations, and you may not have control over all the situations on which you're signing off.

I guess I'm a little concerned about that in this environment with nondiscrimination regulations out and some of the things that the federal government is trying to do in an attempt to run the states. I don't know if anybody's got comments on that, but that's one of the things where I see a potential for conflict in the future.

With that, there's one last chart (Chart 3). I just wanted to touch on some nondiscrimination issues. I don't know if anybody's looking into those.

We haven't really been asked to deal with any of the nondiscrimination issues to date, but I suspect everybody's in the same boat; if you had to apply the nondiscrimination regulations now, most of the systems wouldn't make it, at least not on a safe harbor-type basis. It's because of the nature of the highly compensated population. If you general tested and you had the data, you probably wouldn't have any trouble at all with the majority of the systems. But the fact of the matter is you'd have to general test it to prove it and I don't know if anybody, once again, is talking to their localities or their state systems and doing anything. My impression is they aren't at this point.

The effective date for these regulations for the public systems is 1995, and as we all know a lot can happen between now and then. There is a working group proposal out. A lot of company representatives are helping the states to present proposals to the federal government about what the nondiscrimination regulations should require public plans to do. A number of them have added some safe harbor provisions or grandfather existing provisions like on this sample plan in Chart 3. This isn't any particular state's plan, I just wrote something up here. You can see that you are dealing with situations where you've got some people covered by Social Security, some who aren't, some who have grandfathered provisions because of the change in the plan at some point, some who have early retirement benefits, and some who have different rules than others. Uniformity is clearly violated on the whole group. Salary is base salary rather than some kind of 414(S) definition. There are lot of different issues here and a lot of data are going to have to be collected if you have to comply with these rules.

PUBLIC PENSION PLANS

CHART 3

	Basic	Coordinated (Pre-1989)	Coordinated (Post-1989)
Eligibility	Public employees not covered by Social Security	Public employees covered by Social Security	Public employees covered by Social Security
Number	110,000	80,000	20,000
Member Contributions	8%	4%	4%
Average Salary	Base salary	Base salary	Base salary
Normal Retirement	Age 65 and 3 years 2.5% × years × FAS	Age 65 and 3 years 1.5% × years × FAS	SSNRA and 3 years 1.5% × years × FAS
Early Retirement	Age 55 and 3 years or Rule of 90. Greater of 2% for 10 years + 2.5% after reduced 0.25% each month (unless Rule of 90) or 2.5% with actuarial reduction plus 3% augmentation.	Age 55 and 3 years or Rule of 90. Greater of 1% for 10 years + 1.5% after reduced 0.25% each month (unless Rule of 90) or 2.5% with actuarial reduction plus 3% augmentation.	Age 55 and 3 years. 2.5% with actuarial reduction plus 3% augmentation.
Disability	60% of final salary to age 65 with projected NRB after.	Accrued benefit unreduced plus $5 supplement × years remaining to NRA.	Accrued benefit unreduced.
Death	50% of final salary or surviving spouse benefit.	Surviving spouse benefit.	Surviving spouse benefit.

The working group proposal recommends to the IRS that existing grandfather provisions should not be changed; instead they should get a safe passage. They would also add some safe harbors based solely on concentration percentages of highly compensated employees, change the definition of employer (I think this is a big issue in terms of who the employer is and who you have to test) add a definition of compensation, and recognize some of the other situations that are in public plans like buy-ins and reciprocity. These are issues that can create problems, especially in data maintenance. For example, if you have a state system that has employees moving from one participating employer to another, while the system keeps track of the total benefit, it just moves credited service and items like that over to the latest employer. Some of the past data may not even be there. You may not be able to get a lot of the information with respect to their prior employer, or at least it is not readily available.

The data are probably the biggest issue, because I don't think in most systems we're going to have trouble passing the regulations if they are general tested. But to get all that data together, you are going to create administrative staffs. The bottom line is the constituents are going to pay for it.

And with that I think, unless there's any more questions in this area, I'm going to pass it on over to Robert.

MR. DEZUBE: I'm just going to touch on two more areas: One is the Betts legislation and what some of the other offices of our firm are doing and the other is window plans.

Our Washington, D.C. office has been involved in helping several states and at least one large city comply with the Betts legislation. With respect to one of the states, we did it the easy way. We first wrote a letter summarizing the different options such as designing a new plan for future hires, eliminating the age cut-offs in the disability benefits, etc. We then costed out eliminating the age cut-off which we felt would be the most expensive and basically it is now in the hands of the politicians as to what the state is going to do. This is a state that does not want to comply with anything the IRS has issued, and they're going to probably fight the IRS the whole way. I don't believe they ever put the 415 limits into their plan. They believe in state's rights and are going to wait until the IRS whipsaws them into complying with a lot of these laws.

Our Seattle office did an analysis for another state plan whose disability benefits included a component based on projected service. First there was the question as to whether that benefit was discriminatory. Basically, under this type of formula, people hired earlier get greater benefits as a percentage of pay than people who are hired later. For example, a 40-year-old with 10 years of service would get a bigger benefit than a 50-year-old with 10 years of service. However, the Seattle office, when they did the testing and included the probability of disablement based on the Equal Employment Opportunity Commission (EEOC) regulation approach (this is somebody else's study and I'm not an expert on it), proved that disabled people who have the same service have a higher present value of benefits the later the entry age. I guess that may be intuitive. We were hoping to prove that on a cost basis the benefit was not discriminatory, but that still left the question as to whether or not the design was discriminatory in the first place. And even that probably requires looking at costs.

The Seattle office submitted the work to the EEOC, but the EEOC basically said it could not understand the actuarial work. This gives us a lot of confidence. But we think that the response was or will be negative, though it will be a nonbinding response.

More interesting is what our research department, which is located in our Washington, D.C. office, is doing to help another large city. Under the EEOC rules, you're allowed to use some type of a benefits package approach to prove that benefits are nondiscriminatory. Therefore, we proposed combining the cost of disability, retirement, and medical benefits in proving that benefits do not decrease in cost as people age. We were hoping to show that due to health benefits increasing as one ages, you could provide less valuable disability benefits through the pension plan. However, our health actuaries have informed us and we're still trying to comprehend this. For the majority of cases where people are still working beyond age 65, the people are usually healthy and their medical costs actually decrease compared to preage-65 employees. Of course, if this is true, this would end our plan of attack, but as I said, we're still working on this. If you have any questions on that, you may want to talk to our research department.

We also found that one of the more disturbing aspects of trying to comply with Betts legislation is the lack of guidance from the EEOC. I understand last November representatives of Gabriel, Roeder, & Smith arranged a meeting between the EEOC and several national public employee organizations. During this meeting, EEOC staff indicated they would probably issue an advance notice of proposed rulemaking in the *Federal Register* during 1992. As far as I understand, nothing has materialized to date. During the meeting, the EEOC staff members said that they will answer written inquiries from public plans about implementation. They cautioned however that any response will be informal and nonbinding. Thus, public plans will not be able to rely on a response as a defense in a lawsuit. As I said earlier, we were told that they could not understand our work and the response will probably be negative on the one try we did.

The October 16 compliance date is rapidly approaching and there's still not specific guidance from the EEOC. I understand some state legislatures have already adjourned for the year, so it will be impossible for them to comply in a timely basis.

The other topic is "window" plans which, over the last few years, have been a big topic both on the private side and the public side. And I'd like to talk specifically about what is happening in Florida, where the state legislature is considering putting in a plan. Under the state Freedom of Information Act, I can talk about most of this.

What made the Florida plan unique is that usually when we do any work, we always put in a little caveat that the subject involves legal questions; we are not lawyers and we emphasize that you should get a legal opinion. Most of our clients never get a legal opinion. However, the State of Florida actually got a 30-page opinion letter from a law firm on the window program they were considering. As of now, they have not actually implemented the plan, but I thought what the law firm concluded was kind of interesting. Not that there was anything startling in it; it kind of agreed with what we had been telling the state. The law firm's basic conclusions were that the earlier retirement incentive program would not violate any federal nondiscrimination rules, as long as all benefits provided by the window program accrued prior to the 1995 plan year.

When we started working with the state on this, it was thought that the nondiscrimination regulations would be effective with the 1993 plan year, which in Florida's case begins in July. So we were worried about the window plan getting into that plan year and giving us nondiscrimination problems. At one point, they only wanted to give the window benefits to a group of what they call "senior management." Again we said, "Get a legal opinion, but you probably want to do that in a nonqualified plan." The law firm did conclude that the window plan could be limited by restrictions on the amount of benefits that may be provided through plan amendment in any one year (i.e., the Section 415 limits), and the payment of lump sums not related to benefits could violate the 401(a) rules. This is another subject that our office has been grappling with. You are not allowed, as part of a window or a pension plan in general, to pay lump sum benefits that are not incidental to the main retirement benefit. We have had trouble trying to figure out what is considered a lump sum benefit. In this case, Florida was talking about a benefit of possibly $5,000 or $10,000. The law firm said it could violate 401(a), but it did not really come out and say where the lump-sum cut-off point is.

With respect to age discrimination issues, it considered the window program to be consistent with the requirements of the Age Discrimination and Employment Act as amended by the Older Workers Benefit Protection Act. It did note that care must be taken to ensure that the implementation procedures created an environment in which a decision to accept the offer is viewed a voluntary. The state could not coerce anybody to retire. Again, nothing of this was extraordinary.

It also discussed the employment law perspective and this is something that our firm had not really touched on. They concluded that it remained possible that a disparate impact claim could be brought based upon statistical disparity between the representation of protected groups in the units included or excluded from the offer. However, they concluded there would be significant legal impediments to such a claim. And I think what they were trying to say is that you must be careful about which groups you open the window to, but they thought that it would be hard to prove that you were violating some type of employment law.

Given that we had one state that actually got a legal opinion; we have another state and one other client that are implementing early retirement window programs without getting legal opinions. These two programs are similar and somehow they appear to violate the age discrimination rules or some law, but I just can't quantify my feelings. At the same time, other consultants in my office have said, "Oh, no, they sound like legal plans." I just want to kind of give an overview of what the plans provide to see if anybody else has an opinion. As I said, neither of these clients have ever gotten a legal opinion.

The design allows the people to retire and then they're hired back on a less than full-time basis. So they are doing less work, but they are receiving even a proportionately smaller salary. However, their reduced salary, in combination with their retirement benefits, provides relatively more pay for the amount of work they're doing. But if you compare them to a younger employee and you just compare salary, they would be getting less pay for the same job. Somehow it just doesn't seem legal to me, but as I said they have never gotten a legal opinion on it. One state has implemented it, I believe, last year through legislation. We now have another county who's going to do it. I just wondered if anybody had an opinion on this or if they have ever seen anything like that. The people are rehired, I believe, as consultants. They are not allowed back into the retirement system and I just wondered if when they came back, even though this is a voluntary program, could they suddenly turn around and say, "Hey, I'm getting less pay than John Doe over there who's 20 years younger than me. That's discriminatory."

MR. HOGAN: Maybe a key is they are not really employees any more?

MR. DEZUBE: I don't know.

MR. HOGAN: I guess technically if they weren't an employee, then maybe the Age Discrimination in Employment Act might not necessarily apply to that situation.

MR. DEZUBE: For some reason, public plans always have more complex reemployment rules than private plans. In private plans, usually you just suspend benefits and let people come back to work. But public plans always have all these special rules, and although they consider the people consultants, I'm not quite sure if it's correct.

MR. HOGAN: My understanding is that's it's a pretty tricky line of distinction, because you have to distinguish between what that person's getting paid and whether the type of services he or she is providing are really valuable services on a consulting basis. Also is the employer trying to evade hiring employees? Its similar to a leased employee situation.

MR. MURPHY: I have just two comments about that, neither of which gives an answer, but does provide some conclusions. The first goes along with what was being said. I think the government is very interested in the question of, who is an employee? You see articles in *The Wall Street Journal* from time to time which tell you about the terrible things the IRS, the Department of Labor (DOL) etc. did to small companies, for example, that called people consultants and didn't bother paying Social Security tax and things like that. So I think that's an important question. Is this person an employee or not?

The second comment relates to the fact that if a person doesn't participate in the pension plan, the government is also very interested in that. OBRA-90 more or less says you're either going to be in Social Security or your own pension plan. So there's an issue, first of all, whether or not your client participates in Social Security. And second of all that's another hot topic of interest: they'll probably get upset about all these older people not being in the plan and call that discrimination.

MR. DEZUBE: My boss was at one of those meetings with the people at the EEOC, and he told me a story that came out of it that was amusing and interesting. It showed some of their mindset. He was trying to explain why he thought that using projected service is not discriminatory. And so he said, "What we're really considering is, what is the amount of the loss that the individual has suffered?" Now if a 20-year-old gets disabled, he's lost basically 45 years of potential service so we project 45 years of service. Now if a 50-year-old gets disabled, he has lost only 15 years of future service. Now granted, he may not have had 30 years of prior service with a plan or something, but still, his loss, as far the plan goes, is 15 years and so that's what we project. And he said of one of the gentlemen at the EEOC, "You could sort of see a light go on in his brain as if he was saying, 'Ah-ha! This actuary might be right'." But when the opinion came down the EEOC said, "No, it doesn't matter. It's discriminatory."

MR. ROEDER: I want to just hit on a couple of points that I didn't mention earlier. This again relates to budget crunch situations. In our firm, we've seen a few situations where partly, but maybe not entirely for budget crunch purposes, new employees hired after a certain date have a separate plan created for them -- that's a defined-contribution plan. Has anyone else had those situations where the "answer" to the budget crunch problem is that a successor defined-contribution plan has been put in?

MR DEZUBE: We have one large state plan.

FROM THE FLOOR: Two cases.

MR. ROEDER: Two cases. One of the things I failed to mention about the things going on in California is that there is one legislator who has been fairly prominent in pension legislation: Dave Elder out of Long Beach. There also was latitude to set up a new tier for new employees in the state of California that would cap the employer's outlay to 4% of payroll. And his proposal is basically to have a plan be a kind of a hybrid plan where the employer would basically put in 4% of pay and then the employees would have the latitude to put in any additional pay that they wanted to. So it'd be kind of a quasi-401(k) approach almost. Obviously, there are some legal issues involved in terms of this being a post-May 1986 situation.

There are also some other issues involved from an employee's standpoint. They would probably have to be crazy to put in after-tax contributions if they've got the option of putting money into a 457 vehicle. On a practical basis, if that approach were to be implemented, you'd get a letter a ruling or some guidance saying that this could be done with pretax employee contributions. My guess is that maybe this is something that we will see more of in the next 5-10 years (i.e., there may be more carve-out plans). Again, my viewpoint is a little bit skewed. I think California probably has more two-tiered, three-tiered, and in the case of L.A. County, five-tiered plans than some other parts of the country.

In the late 1970s, after Proposition 13 passed which cut property taxes, a lot of the municipal entities in California were experiencing a panic similar to what a lot of entities across the country are experiencing now with respect to real financial shortfalls. As a result they put in new plans that were less liberal for new employees who were hired after a given date. My guess is that's one of the things that, if the recession continues (and I'm one of those who doesn't necessarily agree with the economists who say that we're out of the recession), might well be one of the by-products. A lot of entities will be looking at less liberal defined-benefit plans, and possibly even looking at going the defined-contribution approach.

I'd be interested in any experiences anyone has in that regard, because that strikes me as kind of a potential new wave as to what might be happening design-wise in the next five or ten years.

I also have some comments on Section 415. As many of you know, there are 415 issues involving long-service public employees, particularly public safety employees who've built up relatively large benefits and still can retire at relatively young ages. We had done some analysis for some entities in the west as to whether they should make the grandfather election that was available to them a couple of years ago in regard to which set of 415 limits they wished to be subject to. Our analysis and the analysis of Caroon & Black for the State of California, as well as our analysis for some other entities, showed that in 90-95% of the situations where a public employee was affected by the 415 limits, didn't really have anything to do with the dollar limits. It had to do with the 100% of compensation limit. Our firm and some other firms have made some efforts by lobbying, and I think the Government Finance Officers Association (GFOA), is also going to be helpful.

What we're hoping will defuse this issue for public employees is that there'll be a bill -- I think Representative Matsui will probably be a spearcarrier for it in the House of Representatives -- changing the definition of compensation. This is one of the big bugaboos for public employees because certain elements in 415 compensation are not the same as for the compensation for benefit purposes, witness Section 457 deferrals. Another possible growing area of deferrals in the future for public employees, especially if there's more cost-sharing shifted to employees, is 125 deferrals. And the hope is that this 415 issue will go away for those affected employees with a legislative change that will make the definition of what counts as compensation for 415 purposes more liberal.

MR. WELCH: Rick, have you had any experience with this? I have one client in Tennessee, a public body, where employees have exceeded the dollar limit of Section 415. I had another one in Florida where the police, who were in the general employees plan and in their own police plan, exceeded the percentage limit. After more than 30 years, they went over 100%.

This was discussed at a meeting of public pension plan actuaries at the Enrolled Actuaries' meeting a year ago in Washington. And when I brought it up, I was told that the solution that my clients were contemplating -- having a third check paid by the public entity -- was a violation of, I think, Section 457(f). That third check became a type of a plan under 457. The whole present value of that payment stream for the individual would be immediately fully taxable income. This is what Ed Friend said when I was in Washington. I read 457(f) and it sure says that. It's quite clear. That's why I was there. So I sent it to the two legal counsels for these two bodies and both of them wrote back saying they didn't see a problem but gave no further description of it. They just didn't see a problem. Has anybody had that experience?

MR. ROEDER: I see the problem. As a matter of fact, it almost is tangential to what Robert was saying about taking a nonqualified route for his window problem. I'm not a lawyer, but I don't think you can just willy-nilly set up nonqualified plans. I think that there are some constraints, and I've heard other lawyers who have expressed concerns similar to yours.

FROM THE FLOOR: Coming at it from the private sector, you can set up a plan for a select group of management and employees in the private sector and not worry about some of the nondiscrimination issues. At least you're not worried about creating a pension plan. What can you do in the public sector?

MR. ROEDER: In the private sector, you're basically in a top-hat plan, where you basically have an amazing amount of latitude. But the concern, from the legal standpoint is, because some of the rules and restrictions in Section 457 have been explicitly set out for public sector employees, it creates a different situation than the private sector. Because of the explicit limits, such as the $7,500 annual limit (except for the three-year catch-up periods and some of the other rules that are listed in 457), doing nonexplicit things in the nonqualified area may present a problem that you don't have in the private sector.

MR. WELCH: It was specifically put in saying you can't do that.