REPORT OF THE BLUE RIBBON PANEL ON PUBLIC PENSION PLAN FUNDING

SUMMARY OF RECOMMENDATIONS

Letter From The Panel Chair

To the Society of Actuaries' (SOA's) Board of Directors and Members:

On behalf of the Blue Ribbon Panel on Public Pension Plan Funding ("the Panel"), I am pleased to submit the attached report of our findings and recommendations. Consistent with our charter, the Panel focused on the development of recommendations for strengthening public plan funding. From my perspective, the Panel's principal objective was to identify effective and practical recommendations for enhancing the ability of plan sponsors to keep the contractual benefit promises that they negotiated with plan participants.

The timing of this undertaking was appropriate as the information considered by the Panel suggests that the financial condition of public pension trusts has weakened during the last 15 years, while its exposure to future financial and other risks has increased, possibly materially. Self-reported funded ratios, the history of sponsors' payment of recommended contributions, greater levels of investment risk taking, and funding analyses that may not have adequately captured the changing economic outlook support this view and have been noted in the Panel's report. The Panel's deliberations were also informed by the challenges facing selected pension systems and the fiscal pressures facing many sponsors. These challenges are significant and if not resolved will impact not only the strength of public pension trusts, but will affect sponsors' ability to provide the broad range of public services that citizens are expecting. In this context, I believe that the failure to adopt these or other recommendations for improving plan funding will exacerbate an already fragile situation. I am optimistic that the Panel's recommendations will be seriously considered by the actuarial profession and other parties interested in assuring the future health of public pension programs.

I would like to thank the many people that responded to our survey and to those that took the time to discuss their views with the Panel. Your input was greatly appreciated. Panel members, I have immense respect for your expertise and energy and I would like to thank each of you for your true passion and commitment to this effort, your hard work, and the spirited debate that shaped our recommendations. I believe that, together, we have made an important contribution to the public dialogue over how to strengthen the public pension plan system.

Bob Stein, FSA, MAAA, CPA

Summary of Recommendations

The funding of U.S. public sector pension plans has received heightened attention in recent years as states and local government entities have responded to the effects of the 2008 financial crisis and several cities have faced high-profile financial challenges. Some observers react with alarm to the current situation, noting the downward trend of reported funded ratios, the increased propensity of sponsors to not pay all of the recommended contribution, growing risk levels in asset portfolios, and the increased risk that funding assumptions will not be achieved. Others note that today's funded levels are similar to funded levels in 1990 and that sponsors and trustees have taken action to respond to the recent turmoil. Nonetheless, these trends raise a fundamental question: What changes in plan funding practices, governance and other matters help ensure that public plans can deliver on the benefit promises their sponsors have made to public employees?

In April 2013, the Society of Actuaries commissioned the SOA Blue Ribbon Panel ("the Panel") to address these questions. This paper reports on the results of the Panel's work.

Plan trustees and those responsible for funding pension plans (funding entities) face many challenges in managing the current and future financial health of pension plans. This report provides a set of principles to help guide sponsors and trustees in their plan funding decisions and to ensure that other stakeholders are informed of those decisions and how they have been made.

The report does not address the appropriateness of current financial reporting for public plans nor whether those requirements should be re-examined. The report does not address the most appropriate means of assessing the economic value of pension benefits. The report recommends actions to strengthen financial and risk management practices by providing new information to trustees, funding entities and their elected officials, employees and their unions, taxpayers and other stakeholders. This information will help stakeholders better understand the risks being taken and borne by plans and how best to develop a long-term funding program. In addition, the Panel makes recommendations about the actuary's role in developing funding recommendations and calls for improvements in plan governance, both of which can foster more effective decision making.

Funding Principles

The Panel believes that pension obligations should be pre-funded in a rational and sustainable manner by funding benefits for employees over their public service career. An effective funding program should follow three principles:

- **Adequacy.** Funding entities and plan trustees should strive to fund 100 percent of the obligation for benefits using assumptions that are consistent with median expectations about future economic conditions, i.e., the assumptions are estimated to be realizable 50 percent of the time. Financial resources, including both current assets and future contributions, should be adequate to fund benefits over a broad range of expected future economic outcomes. Programs should be funded at levels that will enable them to respond to changing conditions and maintain a high degree of resilience in order to cope with uncertain future conditions. The stress testing recommended herein will provide information that will help to develop the requisite financial flexibility.

- **Intergenerational equity.** Intergenerational equity refers to the desire for the full cost of public services, including pensions earned by public employees, to be paid by those receiving the benefits of those services. The Panel believes that fully funding pension benefits over the average future service period of public employees reasonably aligns the cost of today's public services with the taxpayers who benefit from those services.

- **Cost stability and predictability.** The Panel believes that cost stability (i.e., level or nearly level costs over an intermediate period) is often at odds with the goals of adequacy and intergenerational equity. The Panel also recognizes that predictability of costs in the short-term is important for public budgeting processes. Allocating a significant portion of investments to higher-risk, more volatile assets will tend to undermine the goal of cost stability, especially for plans with a rising retiree population compared to active employees. To support the objective of "keeping the pension promise," the Panel believes that adequacy and intergenerational equity should take precedence over the goal of cost stability and predictability.

Recommended Risk Measures, Analyses And Disclosures

The Panel believes that the risk management practices of public pension plans should be strengthened to provide stakeholders with the information they need to make more informed and effective decisions about plan funding, including more comprehensive information about the current and expected future financial position of the trust and of the nature and extent of risks facing public pension plans. The Panel recommends that the following information be disclosed:

- **Trends in financial and demographic measures.** To support an assessment of the implications of trends in the plan's financial position and participant profile, actuarial funding reports should contain, for the past 10 years, information presenting the relationship of benefit payments, funding liabilities, and assets to payroll; the relationship between the recommended contribution to payroll and to the sponsor's budget or revenue source; and the ratio of contributions made to the recommended contribution.

- **Measures of risk to the plan's financial position.** To understand current risk levels, three benchmarks should be disclosed: 1) the expected standard deviation of investment returns of the asset portfolio on the report date; 2) the plan liability and normal cost calculated at the risk-free rate, which estimates the investment risk being taken in the investment earnings assumption; and 3) a standardized plan contribution for assessing the aggregate risks to the adequacy of the recommended contribution.

- **Stress testing.** Stress tests of future financial positions should be disclosed in an effort to measure investment and contribution risks. Such tests, constituting 30-year financial projections, should be conducted using the following assumptions: 1) returns at a standardized baseline and at returns of 3 percentage points more and less than the baseline assumption and 2) funding entities making 80 percent of recommended contributions.

- **Undiscounted cash flows.** Users of plans' and funding entities' financial statements should be able to develop their own calculation of plan obligations. Therefore, the Panel recommends that two sets of benefit payment projections be provided for current employees, one on an accrued (earned-to-date) basis and one on a projected benefits basis.

Recommendations Regarding The Role Of The Actuary

The Panel urges the Actuarial Standards Board (ASB) to require the financial and risk measures outlined above be disclosed in actuarial reports. It also urges the ASB to require actuaries to include in their actuarial reports an opinion on the reasonableness of funding methods and assumptions. Finally, the Panel makes specific recommendations on methods and assumptions used by plans for the purposes of funding calculations; specifically, discount rates, amortization periods, asset smoothing, and the use of direct rate smoothing or alternative funding methods:

- **Discount rates.** The Panel recognizes that historical returns, adjusted for expected changes in future conditions, are a common reference point. However, the Panel believes that the rate of return assumption should be based primarily on the current risk-free rate plus explicit risk premia or on other similar forward-looking techniques.

- **Amortization periods.** Amortization of gains/losses should be completed over a period of no more than 15 to 20 years.

- **Asset smoothing.** Asset smoothing periods should be limited to five years or less

- **Direct rate smoothing methods.** The Panel encourages the consideration of direct rate smoothing and other asset and liability cash flow modeling techniques. Such approaches can provide greater transparency into the current financial position of the trust, the level of risk in funding assumptions, and enhanced flexibility to sponsors in the development of sustainable funding programs. The Panel notes that care must be exercised in the use of such approaches to avoid deferring contributions that would reduce the ability of the funding program to meet adequacy and intergenerational equity goals.

Recommendations Regarding Plan Governance

The Panel considered governance in its broadest definition: how stakeholders responsible for plan funding make and implement funding decisions. Each pension system structure is unique and the Panel makes no specific recommendations on the best governance structure. However, several characteristics of good governance that all systems should adopt are recommended, including:

- Maximizing the likelihood that funding objectives outlined by the Panel will be achieved. This includes ensuring that recommended contributions are paid, disclosing complete information about the plan's finances to all stakeholders, and not using funding instruments and other financial instruments that delay cash contributions.

- Ensuring trustees have sufficient information and institutional structures to analyze risk, including establishing guidelines for the amount of risk that can be appropriately assumed.

- Providing proper and timely training of trustees.

- Carefully considering of plan changes, such as requiring that consideration and adoption of plan changes be completed over two legislative sessions (or their equivalent), adopting a formal process for evaluating the emerging cost and participant implications of adopted plan changes and avoiding certain high-risk plan features while actively considering plan features that enhance plans' flexibility for responding to unexpected experience.

The Panel's recommendations were developed following an extensive information gathering and analysis process. The Panel's recommendations are those of the Panel and are consensus recommendations, with the exception of Mr. Musuraca. Mr. Musuraca was an active and valuable participant in the Panel's discussions and deliberations, but concluded that he could not fully support this report's findings and recommendations.