SPECIAL REPORT

Debunking Myths about Texas Public Employee Pensions

REPORT #1:

Fact and Fiction in the Laura and John Arnold Foundation Solution Paper “Creating a New Public Pension System”

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TEXpers
Texas Association of Public Employee Retirement Systems

Fact and Fiction in the Laura and John Arnold Foundation Solution Paper "Creating a New Public Pension System"

Executive Summary: On December 1, 2011 the Laura and John Arnold foundation released its first policy paper, "Creating a New Public Pension System," which it claims outlines "effective alternatives to the current pension system." After careful review, TEXPERS found numerous examples of exaggeration, hyperbole and questionable fact-finding in the policy paper. In the spirit of informed debate, TEXPERS created this paper to balance some of the claims and assertions the LJAF paper contains with facts as we know them.

LJAF Assertion #1:

> *"Failing to address the public pension crisis promptly would be economically catastrophic, triggering bankruptcies of cities, school systems and potentially even entire state governments."*
>
> *"The states' own estimates of the unfunded liability due to their pension benefit promises grew to $1.26 trillion in fiscal year 2009, up from $1 trillion just one year earlier. However, using standard private sector accounting rules, the shortfall estimate increases to approximately $3 trillion, a sum that represents roughly one-fifth of the United States' gross domestic product."*

Facts:

$3 trillion is a grossly overstated figure that should be reviewed and modified according to standard accounting principles and theory. First, how is this number derived? There has been much debate as to how unfunded liabilities are calculated and the impact of this calculation on public pension plans.

The standard by which public pension plans calculate their unfunded liabilities is called the actuarial method. It is recommended (by the General Accounting Standards Board - GASB) and it is by far the most commonly used method that public pension plans and financial professionals use to calculate unfunded liabilities. This method uses a "discount rate" to determine the present value of a public pension funds' obligations. The percent is computed by taking into account the historical average rate of return of the funds' investments. Public pension funds invest their assets for the long term, which means above and below average returns will be averaged out in the formula. Most public pension plans use a standard discount rate of 8 percent. When using this formula, unfunded liabilities are calculated and reduced drastically to roughly $700 billion.

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Dr. McGee's figure of $3 trillion results from a highly critical and controversial assumption wherein pension plans are essentially penalized for ensuring the financial security of their recipients. Dr. McGee ascertains that public pension plans should be penalized for making prudent investments and having sound investment guidelines in place. He has accepted the notion that public pension plans use a "riskless rate" as their discount rate. The riskless rate penalizes public pension funds because it classifies pension obligations as guaranteed and because of this guarantee, the discount rate should be based on returns from the funds safest investment - US Treasury bonds.

However, the truth is that the average rate of return for investment portfolios of public pension plans beats the riskless rate due to the diversification of its asset classes. Dr. McGee fails to note that this method is one that is only accepted by a handful of economists and has not been accepted by GASB. Also, while financial firms are aware of both methods, they do not use the riskless rate since it has not been adopted by the GASB as an accounting standard. Furthermore, Dr. McGee fails to inform the public that most economists agree that the investment practices of public pension funds should not change.

Conclusion: When utilizing the discount rate in the actuarial method to determine unfunded liabilities, Dr. McGee's figure of $3 trillion becomes grossly overstated and inaccurate. In fact the number drops substantially to approximately $700 billion and the funding level stays at or about 80 percent, which is considered acceptable to many public plans. It is also worthy to note that most public pension plans have an investment policy in place that monitors expected rates of return and other investment factors as well. Dr. McGee is mistaken to think that catastrophic events such as a $3 trillion shortfall and bankruptcies of cities, school districts, and state governments will take place in our society due to his grossly inaccurate figure.

TEXPERS' assessment:

> Even though we are in the worst economic environment since the Great Depression – cities, state governments, and school districts do not face a liquidity crisis. Governments and other public entities will continue to exist. The investible assets in public pension plans face peaks and valleys similar to business and economic cycles. History has been on the side of public pension funds, as roughly $3 trillion was accumulated into pension fund accounts from 1980 to 2007. There is no reason to think this won't happen again, once the stock market and economy recovers.

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LJAF Assertion #2

"The way to create a sound, sustainable and fair retirement savings program is to stop promising a benefit and instead promise an accrual or savings rate. This would mean that instead of committing to a fixed percentage of final average salary after a specified number of years of service, the employer would instead commit to contributing a fixed percentage of salary for every year worked. This would eliminate cost uncertainty by making benefits a constant percentage of earnings and by linking benefit promises directly to employer contributions. Under this approach, employers can be as generous as they desire with employees without the danger of underfunding. Additionally, employers can adopt and offer to employees a variety of investment strategies for the retirement funds, minimizing costs, creating choices for workers, and limiting market exposure for both the employee and taxpayers.

A shift toward promising a savings rate instantly fixes the structural problems created by the current system and can be implemented in a way that maintains all of the protections for workers that are hailed as the primary benefits of the current system (e.g., easy annuitization, managed investments, employer-employee risk sharing). There is a range of specific options for making this shift. Recent reform efforts have shown that implementation of new systems is very flexible and certainly not "one size fits all."

Fact #1:

The promise of receiving a guaranteed benefit is the most feasible option for retirees and current employees seeking a secure retirement.

- By contrast, most defined contribution plans are optional to the employee. It is up to them as to whether they want to enroll and save for their retirement.
- Employees can also choose what percentage they want to contribute, up to the maximum allowed by law.
- Furthermore, this fixed percentage doesn't take into account cost of living adjustments whereas defined benefit plans factor in this adjustment for retirement benefits.
- Lastly is the notion that employers will contribute to the employees DC plan. The truth is employers don't have to contribute a penny to help with their employee's retirement.

Fact #2

There are considerably more costs and risks associated with defined contribution plans. Here are just a few:

1) **Investment Risk**
    a. Defined **benefit** plans in the private sector place all of the investment and inflation risk into the employer's hands. However, public plans share this risk between the plan and the local government. The benefit is that the pension

funds have written investment guidelines and place their investment portfolio into the hands of financial professionals to follow those guidelines. This takes the risk of making investment decisions out of the hands of employees (regardless of their investment and financial background) and the burden of worrying whether or not they are making prudent investment decisions for their retirement.

b. By contrast, defined **contribution** plans put all of the investment and inflation risk onto employees. This leaves them solely responsible for their own destiny, which could have catastrophic results if the investment decisions prove to be bad. Employees are simply given a choice of different investment options and left to decide and hope which options will be the best for them. Many employees are so overwhelmed with their investment options and where to place their money, they leave the money sitting in a default investment choice – which is usually an option tied to a money market index or a treasury index. The result is a rate of return that doesn't exceed the average rate of inflation of 4%.

One can look to the retirement choices that Enron Corp. provided their employees before it imploded. Employees were encouraged to put a portion of their retirement savings into company stock or a profit sharing plan which was invested directly in company stock. Most employees that chose this option did so based on the assumption of the company's public and presumed financial status, not prudent investment research. The result – tens of millions of dollars in retirement savings lost and thousands of employees losing their "nest egg" for retirement.

2) Administrative Costs

a. Defined benefit plans incur relatively less administrative costs than defined contribution plans. By managing a large pool of assets, overall expenses tend to be significantly less than those associated with defined contribution plans. The only additional expenses incurred are for the actuarial and investment advice.

b. Defined contribution plans are more complex to manage and cost more to administer for a number of reasons.

- **i.** They are managing thousands of individual accounts where investments can be rebalanced by the employee on a daily basis. Every time there is a fund change within an employee's account, there is an expense associated with that.
- **ii.** There are costs associated with providing investment education and administrative costs for services such as loans, hardships, and/or retirement benefits. More often these costs are shifted to the employee.

3) **Accessibility and Payment of funds**
   a. Defined benefit plans don't allow access to retirement funds prior to retirement. Whereas, defined contribution plans allow access to funds and even the ability to liquidate your account before retirement. This reduces that amount of money at work for the employee and lessons the probability for adequate retirement nest eggs.

   b. By contrast, a guaranteed monthly payment is distributed upon retirement when money is invested in a defined benefit plan. Money that is in a defined contribution account is received in a lump sum, allowing the retiree to do what they please with their retirement funds.
      i. It is important to note that DC plan accounts are subject to market volatility, which means the value of their retirement account could be severely depressed if sound investment decisions are not made. Employees are dependent on their own financial and investment background for making the appropriate decisions about their financial future. One mistake is all that is needed to ruin someone's retirement.

Conclusion
Based on the truths we now know about DB and DC plans, let's break down the LJAF Foundation assertion,

> *"A shift toward promising a savings rate instantly fixes the structural problems created by the current system and can be implemented in a way that maintains all of the protections for workers that are hailed as the primary benefits of the current system (e.g., easy annuitization, managed investments, employer-employee risk sharing)."*

The fact remains that DC plans are simply not good for employees.

DB plans have an infrastructure in place that allows for prudent investing and a secure retirement for its retirees. DC plans takes away all the responsibility from the employer and places it solely into the hands of the employee. To be blunt, they are essentially telling an employee "We don't care about you or your service." Whereas DB plans are utilizing resources from financial firms, actuaries, etc. to make prudent investment decisions on behalf of the employee and promising guaranteed benefits to them when they retire.

TEXPERS' Assessment:
In our view, there is a fundamental question that the LJAF report needs to consider.

> Which plans produce the greatest possibility of retirees having no money for retirement?

In our view, the likely failure of DC plans to produce adequate retirement funding will put a tremendous strain on local economies as more people turn to public assistance in their retirement years. This will result in tax increases to help support those retirees.

Furthermore to say that DB and DC plans have the same primary benefits is simply not true. DC plans don't annuitize their payments, they distribute in a lump sum amount. DC don't manage investments, the employers puts the entire responsibility of making investment decisions into the hands of the retiree.

And finally DC plans don't share any of the risk, they pass off 100% of the risk to the retiree.

We will continue to promote defined benefit plans as the best public policy prescription for public sector employees.