Retirement News Highlights

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Long live public pension funds!

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When Pensions & Investments launched in 1973, the passage of ERISA was on the horizon and corporate defined benefit plans faced a bright future that has since faded as the majority of private-sector workers have been moved to defined contribution plans.

Will public-sector DB plans face a similar fate? Experts say despite numerous challenges, including lower capital market projections, rising contribution rates and an often charged political environment, public pension plans should continue to "muddle through" for decades to come.

Anthony Randazzo, executive director of the Equable Institute, a bipartisan, nonprofit organization that focuses on public-sector retirement systems and their funding challenges, said in an interview that so many public pension plans remain open because "in the ideal form, pensions are really great benefits."

In the corporate space, however, Randazzo notes that companies always balanced the cost of benefits against their usefulness as a recruiting-and-retention tools.

"In that context, it was a lot easier for corporations to shift away from pensions because of the increasingly high costs these plans have had," Randazzo said.

On the public-sector side, Randazzo said pension plans have persisted because the benefit has been seen as necessary for generations now "and thus it's politically challenging to tackle pensions."

Both corporate and public pension plans had the great fortune during the 25 years before the global financial crisis of being present in a spectacularly beneficial market return environment.

Robert "Vince" Smith, deputy state investment officer and chief investment officer of the New Mexico State Investment Council, Santa Fe, which oversees $44.1 billion in endowments, said at a June 27 council meeting that "It was fantastic because you could build a portfolio with lower levels of risk" and count on returns from fixed income.

Following the financial crisis and a massive expansion of the money supply, institutions still had OK returns, Smith said. However, he said that ability of the central banks to continue creating debt and putting that into economies doesn't exist anymore, pointing out the U.S. government spending $15 trillion from 2009 to 2021.

"We really think we've shifted into a different economic and investment environment," and investment returns will be lower in the years ahead, he said. Smith was previously CIO of the $25.6 billion Kansas Public Employees' Retirement System, Topeka, from 2006 to 2010.

Others agree. According to the Equable Institute's latest annual report — State of Pensions 2023 — a standard pension fund has only a 50% chance to earn 5.6% over the next 10 years or 6.3% over the next 20 years.

For their part, U.S. public pension plans have gradually made their rate of return assumptions more realistic, with the average falling to 6.88% in 2023 from 8.07% in 2001, according to the Equable Institute report.

Unlike corporate pension funds, which are required to use a discount rate equivalent to an AA-rated bond in order to determine future obligations, public pension funds utilize their rate of return assumption as their discount rates.

An unrealistically high rate of return assumption could lead to an inaccurate picture of future pension obligations.

"It's not clear to me that pension funds have stopped their transition to lowering their return assumptions," said Jean-Pierre Aubry, associate director of state and local research at the Center for Retirement Research at Boston College. "The trajectory that they're trying to get down to? 6% is their number."

He noted that while the average assumptions might still be higher than is realistic, "these are kinds of Titanics and move incrementally … The recognition is that maybe they need to revisit assumptions, but they can't do it within one fell swoop because of the budgetary impact," he said.

Public pension plans have been revisiting their assumptions for years, and have made other moves in order to reduce the costs of plans, especially after the one-two punch of the dot-com recession of 2000 and the Great Recession eight years later.

"I think the defined benefit plans are here to stay, although there is a movement toward those plans becoming more risk sharing," said Gene Kalwarski, CEO , principal consulting actuary and co-founder of Cheiron.

Aubry concurred, citing efforts by various states and municipalities to create new tiers of benefits, increase the rates of contributions by employees and employers, and control cost-of-living adjustments.

U.S. corporate and public pension plans experienced a significant funding crisis after the two recessions and while many corporations have addressed the issue by closing and freezing their plans or transferring assets and liabilities to insurance companies, governmental entities generally avoided those steps.

In Illinois, for example, where pension benefits for public employees are protected under the state constitution, a new tier of benefits for newly hired employees was the only way to be able to try to address the funding crisis.

For example, in 2011 state legislation created a Tier 2 benefit for the $67 billion Illinois Teachers' Retirement System, Springfield. Employees hired after Jan. 1, 2011, are required to reach 67 years old and have accumulated at least 10 years of service credit to qualify for unreduced benefits. That was raised from 62 years old for employees hired before Jan. 1, 2011.

Not long afterward in Ohio, then-Gov. John Kasich in 2012 signed into law five pension reform bills each covering one of the state's five retirement systems. One of those five systems, the $90.1 billion Ohio State Teachers' Retirement System, Columbus, saw employee contributions raised to 14% from 10% and its board given the authority to change the COLA on an annual basis, a change from the previous automatic 3% COLA.

Similar changes across dozens of states and municipalities have helped ensure the long-term survival of public pension plans, Aubry said.

"Benefit cuts, COLA changes, and just hiring fewer workers," said Aubry. "In changing plan designs, they have more hybrid systems, systems that share risks. At least they are building themselves for the long haul by making these kinds of adjustments, and yes, returns will be lower but that's the reason they had to make these changes."

Industry experts also note that after the Great Recession, governmental entities learned their lessons and assess their risks far more robustly.

"We're constantly doing projections," said Cheiron's Kalwarski. "Not just projections based on the assumption, more often they are requiring us to assess the risks these plans face." Cheiron is an actuarial consultant for a number of public pension plans.

Among the new requirements to assess those risks would be robust stress tests in which best-case and worst-case scenarios are determined based on investment returns and contributions.

"The reporting is much more robust than it was 20 years ago," he said.

The state retirement systems in Pennsylvania, for example, now publish an annual stress testing and risk assessment report. This is in addition to state pension reform signed into law by then-Gov. Tom Wolf in 2017 that moved new workers hired after Jan. 1, 2019, that are not in high-risk jobs such as state police and corrections officers into a hybrid retirement system, receiving half of their benefits from the current taxpayer-

funded plan and half from a 401(a) defined contribution plan.

Newly hired workers can now elect to solely participate in the 401(a) plan.

The $35.5 billion Pennsylvania State Employees' Retirement System, Harrisburg, just published its latest stress testing and risk assessment report on Sept. 19. Completed by actuarial consultant Korn Ferry, the report provides comprehensive information on investment risks, demographic risks, and contribution and governance risks.

In the report, Korn Ferry said that even though "unfavorable investment performance" can cause the funding ratio to drop, it is still expected to increase in the long-term due to increasing actuarially determined contributions.

Despite the challenges public pension plans are experiencing, the lessons learned following the Great Recession should contribute to their continued survival.

"Looking at the history of how changes are made to these systems, and also knowing what kinds of legal protections exist in most states," said Equable's Randazzo, "my best guess is that public plans as a whole will continue to muddle forward."

Because investment return assumptions will be lower and market volatility will increase, Randazzo said the volatility in funded status will increase a bit over the next decade, meaning some years the average ratio might be in the mid to high 80s, and other years in the low 70s. “It’s all going to kind of stay about where we are,” Randazzo said, “and I think that’s unfortunate.”

“The retirement system administrators across the country should collectively be telling the leaders in their states that it just continues to be irresponsible and unrealistic to be asking the pension fund managers, the investment managers, to be trying to hit the investment target that they’re trying to hit, and that means more contributions are needed.”