MANAGING RISK IN STATE PENSION PLANS

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Strengthening Public Sector Retirement Systems
The Pew Charitable Trusts

➢ More than 40 active, evidence-based research projects

➢ Projects include public safety, immigration, elections, transportation, pensions, and state tax incentives

➢ All follow a common approach: data-driven, inclusive, and transparent

Pew’s Public Sector Retirement Systems Project

➢ Research since 2007 includes 50-state trends on public pensions and retiree benefits relating to funding, investments, governance, plan design, and retirement security

➢ Technical assistance for states and cities since 2011
Principles for Fiscal Sustainability and Retirement Security

➢ No one-size-fits-all solution, but **key principles** can guide any reform process.

➢ **Fiscal sustainability principles**
  - Commit to fully funding and paying for pension promises.
  - Manage investment risk and cost uncertainty.
  - Follow sound investment governance and reporting practices.

➢ **Retirement security principles**
  - Target sufficient contributions and savings to help put employees on a path to a secure retirement.
  - Invest assets in professionally managed, pooled investments with low fees and appropriate asset allocations.
  - Provide access to distribution options, including lifetime income in retirement.
Overview

➢ Risk in State Pension Plans

➢ Managing Risk Through Alternative Plan Designs

➢ Managing Risk Within DB Plans

➢ Risk Managed Hybrid as an Example of Doing Both

➢ Other Approaches to Managing Risk
RISK IN STATE PENSION PLANS
State Pension Plans Have Taken On Substantial Risk

➢ Even after nine years of recovery, unfunded liabilities remain at historic highs.

➢ Employer contributions have nearly doubled as a share of own-source-revenue since 2001 yet still fall short of what is needed to keep the funding gap from growing.

➢ The gap between what a safe investment can deliver and what pension plans assume in returns has grown rapidly since the early ’90s.

➢ State pension plans have negative operating cash flow, making them dependent on investment performance.
PUBLIC PENSIONS VULNERABLE TO NEXT ECONOMIC DOWNTURN

In aggregate, state and local pension systems have never been more exposed to market volatility, based on fiscal, economic, and actuarial measures.
Policy Can Manage Risk

➢ As unfunded liabilities have increased by close to $1 trillion since the Great Recession, states have taken action.

➢ Nearly every state has made some level of change to employee benefits, employee contributions, or both.

➢ The majority of these changes keep the same basic plan structure without reducing the riskiness and volatility of costs.

➢ A number of states have adopted new plan designs, or made changes within existing plan designs, to mitigate risk to taxpayers.

➢ States like Tennessee and Wisconsin that have historically kept their pension plans well-funded can serve as examples to state and local policymakers looking for solutions.
MANAGING RISK THROUGH ALTERNATIVE PLAN DESIGNS
50 State Reform Summary

➢ Nearly every state has implemented some kind of reform since 2009.

➢ Many reforms changed plan provisions for new workers, but kept the basic structure of the plan.

➢ A number of states passed reforms that affected current workers or retirees since 2009:
  o 24 states reduced COLAs for active and/or retired members
  o 37 states increased employee contributions for either current or new members

➢ Since 2009, at least nine states passed reforms that changed the mandatory benefit design for new employees. Overall, 23 states have a mandatory or optional alternative benefit design.

Plan Design Definitions

➢ Defined Benefit Plan (DB): A plan in which the employer promises a specific amount of monthly retirement income based on a formula that typically takes into account the employee’s salary, years of service, and age.

➢ Defined Contribution Plan (DC): A plan in which retirement savings are based on accumulated employer and employee contributions and the investment returns on those contributions.

➢ Hybrid Plan: Combines elements of DB and DC plans
  • Side-by-Side Hybrid: Plan combines a DB component with a separate DC retirement savings account.
  • Risk-Managed Hybrid: Side-by-side hybrid with additional risk sharing on the DB component.

➢ Cash Balance Plan (CB): Pooled and professionally-managed employee savings accounts with a guaranteed minimum annual investment return and an option for lifetime, guaranteed benefit.
Growing Number of States with Alternative Retirement Plan Designs

23 states have implemented an alternative plan for workers.

Notes
- In cases where a state has more than one alternative plan, the plan type with the greater number of participants is marked on the map. This includes Indiana where workers choose between a hybrid and DC plan, Michigan where state workers are in a DC plan and teachers have a choice between a DC and hybrid, and Ohio where workers choose between a DB, hybrid or DC plan, and Utah where workers choose between a hybrid and DC plan.
- Texas’s cash balance plan is only available to local workers.
- In addition, California provides an optional cash balance plan for part-time workers and adjunct educational employees.

Sources: NASRA, NCSL
Alternative Plans are the Default or Mandatory Option in 16 states
Seven of the 10 default hybrid plans have been adopted since 2006

Notes:
• In cases where a state has more than one alternative plan, the plan type with the greater number of participants is marked on the map. This includes Indiana where workers choose between a hybrid and DC plan, Michigan where state workers are in a DC plan and teachers choice between a DC or hybrid plan, and Utah where workers choose between a hybrid and DC plan. Twelve states total offer a default or optional hybrid plan.
• Texas provides a cash balance plan to over 400,000 local workers through the state’s Texas Municipal Retirement System and Texas County and District Retirement System.

Sources: NASRA, NCSL
What do alternative plan designs mean for employers and employees?

➢ The alternative plan designs adopted by states share risk between employer and employee.

➢ That makes costs more certain for taxpayers but means that the final benefit available to retirees will depend on how investments perform.

➢ The alternative plan designs adopted by states typically do a better job of putting shorter-tenure workers on a path to retirement security than final average salary defined benefit plans.

➢ While some states have moved entirely to DC plans, it has been more common to adopt plan designs that maintain some level of defined benefit while providing more predictable employer costs.

➢ Changes to new plan design will change the fiscal picture for states over time but have no impact on the existing unfunded liabilities.
MANAGING RISK WITHIN DB PLANS
Cost-sharing in DB Plans

➢ States and local governments can include cost-sharing features within the DB plans they offer to reduce cost volatility while keeping the underlying benefit structure.

➢ Two typical ways of sharing costs:
   • Variable employee contribution rates
   • Variable COLA

➢ Some states, like Wisconsin, do both.

➢ Employee contributions can either be set at a fixed share of the actuarial cost (AZ) or increase or decrease specified amounts based on investment performance (PA).

➢ COLA provisions can be based on plan funding levels (MT) or a combination of plan funding levels and investment performance (WI).
Cost-Sharing is Used in Traditional DB Plans

29 DB plans in 17 states have formal cost-sharing policies.
Plan Design is More Important than Plan Type

➢ States using cost-sharing features in DB plans show that what matters is how the design of a retirement plan works in terms of cost, risk, and retirement security.

➢ There is no one-size-fits-all solution to pension challenges facing states and there are multiple successful approaches within the public sector.

➢ States like Wisconsin have also added design elements to the DB plan to address concerns about retirement security for short- and medium-term workers.

➢ Regardless of which approach policymakers choose, fiscal discipline and good governance will be necessary for success.
RISK-MANAGED HYBRID AS AN EXAMPLE OF DOING BOTH
## Features of Standard and Risk Managed Hybrids

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<th>Hybrid Feature</th>
<th>Standard</th>
<th>Risk Managed</th>
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<td>Smaller DB multiplier increases cost predictability.</td>
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<td>Separate DC component that improves the worker savings rate.</td>
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<td>Formal DB cost sharing to distribute unexpected cost increases between employee and employer.</td>
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<tr>
<td>DC component minimizes risk for employees through adequate savings rate, low fee investment options, and appropriate distribution options.</td>
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Note: Michigan also recently adopted a risk managed hybrid plan for teachers. However, the risk managed hybrid plan is not the default. New teachers are defaulted into a defined contribution plan with the option to select the hybrid plan.
Connecticut’s Risk Managed Hybrid
CT adopted a RMH that distributes investment shortfalls below 6.9% between the employer and employer.

Note: Includes employer and employee contributions to the DC component as well DB component.
OTHER APPROACHES TO MANAGING RISK
Plan Design Not Only Way to Manage Risk

➢ **Investment allocation**—Moving investments to safer, simpler, and less volatile assets can reduce the riskiness of a pension plan’s investments. Tradeoff will typically be lower expected returns.

➢ **Contribution policy**—Adopting contribution policies that will better fund in good times can allow for a greater buffer against downturns.

➢ **Stress testing**—Monitoring risk can allow policymakers to better plan for downturns.

➢ Reducing risk will have inevitable tradeoffs with cost or retirement security.
Conclusion
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➢ State pension plans as a whole have never been more vulnerable to the next downturn.

➢ Policymakers have access to a range of tools to manage cost and, more importantly, risk.

➢ A number of states are adopting new plan designs or adjusting their existing DB plans to share risk between employers and employees.

➢ New plan designs won’t address the cost or risk of existing liabilities that have already been promised.

➢ The important question for policymakers is what plan design will be affordable and sustainable while putting all public employees on a path to retirement security.