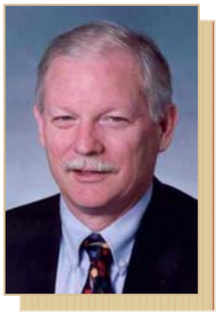
May/June 2009

Pension Math Is Hard to Solve

By Jim Mosman, NCTR Executive Director



In mid-June a group of NCTR System Executives met in Newport, Rhode Island, to discuss issues impacting public pension plans. Without question the impact of declining investment returns was the paramount concern of the group. In almost every state and municipality, the scenario of reduced funding is being considered by pension plans, employers, and plan members. As the fiscal year ends on June 30 for many plans, it is almost certain that investment losses will have to be factored into the next actuarial report. Smoothing methodologies will mitigate some of the pain, but these negative investment returns are likely to trigger undesirable consequences.

Let's revisit the Basic Retirement Funding Equation: C + I = B + E

C = Contributions
I = Investment Income
B = Benefits Paid
E = Expenses (administration)

Most of us are quite aware that Investment Income has played a huge role in the funding of defined plans. It typically produces much more income to the pension plan than employer and employee contributions combined. The decline of investment markets in the last year has resulted in significant reductions to the funding of most plans. This has consequences to the basic pension equation. Once such losses occur, then over time something has to happen to bring the equation back into equilibrium. This can occur in one of three ways (or a combination thereof):

- Markets recover and investment gains replace losses
- Contributions are increased to offset investment losses
- Benefits are lowered to offset the loss of income

The pivotal question at this point is which course of action must occur to return the plan to equilibrium? Perhaps the most expedient, but painful, course of action may be to raise employer and/or employee contributions. For both governments and individuals, increased contributions are a tough pill to swallow in an economic recession. However, it may be even more difficult to adjust benefit levels. In most jurisdictions, pension benefits are viewed as property rights and cannot be reduced once they are given to an individual. A new "tier" may be established with a lower level of benefits, but it may often apply to only new employees. For this reason, it often takes many years for a new tier to produce meaningful cost reductions for the pension plan.

> *"Absent a rapid market recovery, the options are painful.."*

Recovery of the investment markets is obviously the most desirable course of action. Unfortunately, pension plans, employers, and plan members have no control over this variable. Market recovery could in fact take years to bring plans back to their former funding status. In the meantime, it probably is not prudent to gamble on an immediate market recovery, and actuarial reports are going to suggest that there is an immediate need for additional contribu-

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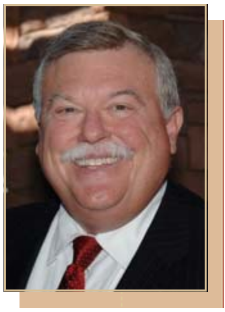
CAPITOL COMMENTARY

GASB and MVL: Speak Up!

By Leigh Snell, NCTR Federal Relations Director



The Governmental Accounting Standards Board (GASB) is considering changes to its rules for accounting and reporting on public pension benefits. Your eyes may already be glazing over, but this project is critically important to governmental plans. Pay attention!

Currently, public plans estimate rates of return (present value discount rates) based on expected long-term gains on investments. However, depending on this GASB project, public plans could be required to use a risk-free rate instead. The resulting valuation of liabilities using this discount rate is commonly referred to as the "Market Valuation of Liabilities" approach, or MVL.

Instead of an assumed rate of return of from 7 to 8.5 percent (the current range for most public plans' discount rate), MVL would require plans to use a rate based on long-term government bond yields, such as 30-year Treasuries, currently below 5 percent. Furthermore, while many governmental plans "smooth" investment gains and losses over a period of time (typically 5 years) when calculating their funded levels, MVL would require the use of the market value of assets as of the valuation date.

Until recently, the likely consequences of MVL were more theoretical. Now, however, thanks to a recent study by Gabriel, Roeder, Smith & Company (GRS), empirical information about the funding patterns and contribution rates resulting from MVL is available – and it is startling.

GRS applied MVL to a modeled plan from 1978 through June 2008 and then compared the results with those obtained by applying the conventional approach. For the 30-year period, GRS found that under the conventional approach, normal costs averaged 8.1 percent of covered payroll, with a standard deviation of 1.1 percent. But when the MVL method was used, normal costs averaged 17.2 percent, with a standard deviation of 9.6 percent.

"The impact on contributions is even more alarming."

The impact on contributions is even more alarming. Under conventional funding, total contributions were 8.5 percent of covered payroll in 1978 and increased to 13.2 percent in 2008. However, under MVL funding, the contribution rates swung widely, from 7.5 percent in 1978, falling to 2.8 percent in 1985, then increasing to 11.3 percent in 1986, and remaining between 8 percent and 12 percent through 1991. After 1991, contribution rates rose rapidly to about 40 percent in 2003, falling to about 25 percent in 2007, and then jumping again to 34.5 percent in 2008.

Based on this data, GRS concluded that the MVL approach "would likely result in rapid and erratic changes to a public plan's normal costs, accrued liabilities, and funded levels" and that the "*serious instabilities in the MVL measures would most likely lead either to erratic demands on government resources or plan terminations.*"

Boards of trustees, system sponsors, plan beneficiaries, and taxpayers need to understand these consequences fully; the GRS report can be found at http://www.soa.org/files/pdf/2009-chicago-ppf-paper-jones-zorn-murphy.pdf. End-users of governmental accounting reporting and disclosures must let GASB know that imposing MVL would be a dangerous and costly change that is misguided and unnecessary.

GASB's review raises many issues, but none is more important than MVL. The deadline for comment is July 31st. NCTR will be filing comments, but GASB also needs to hear from you! ❖

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Pension Math

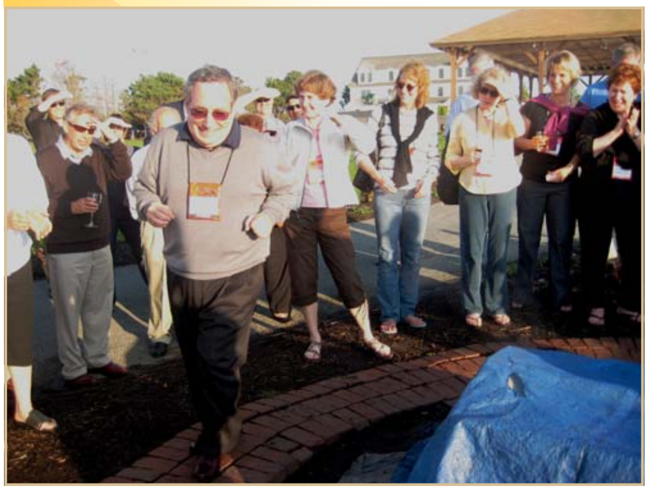
tions to keep the plan viable. In some plans, with a weak funding position at the outset of the market decline, it may be even more critical to provide additional funding so that the plan does not erode to a point of no return.

Thus, this is really a hard equation to solve for the pension plan, the employer, and even the member, as all may face consequences. Absent a rapid market recovery, the options are painful. Most of us in the business believe that patience will be rewarded and, over time, funding levels will improve to satisfactory levels. In the interim there may be the need for modest adjustments to both contributions and benefit levels. But we caution against draconian solutions that either damage plan participants or place unreasonable burdens on employers. We also caution against gimmicks and false solutions. New tiers may appease some, but they do not solve the problem in the short run.

The only silver lining to all of this is that while the decline in investment markets has hurt defined benefit plans, hopefully they will survive and plan participants have been protected in the short run. In defined contribution plans, however, the impact has been immediate on plan participants. Many have been forced to change retirement plans and some have seen almost all of their retirement savings disappear. ❖

SNAPSHOTs

22ND Annual SystemDirectors' Meeting



Alan Belstock (ERFC-Fairfax County, Virginia) trots around the clambake pit, celebrating his birthday. A tradition, claimed the chef, that ensures a perfect dinner for all.

NCTR ANNUAL CONVENTION: CHALLENGING TIMES

JOIN US THIS OCTOBER IN INDIAN WELLS, CALIFORNIA

Session Highlights...

Sunday, October 11

The Future of Teacher Pensions

Monday, October 12

Keynote Address: The New President's First Year
Katty Kay, BBC Correspondent

The U.S. and Global Economy

China's Role in the Global Economy
Dr. Barry Naughton, Prof. of Chinese Economy, UCSD

Tuesday, October 13

Harm J. de Blij, Geographer, Author, Professor

Gary Black, CEO, JanusINTECH

The Labor Perspective
Damon Silvers, Associate General Counsel, AFL-CIO

Wednesday, October 14

What's New in Corporate Governance?

Leadership in a Difficult Environment

Legislative Session

Tuesday Evening...

2009 National Teacher of the Year Dinner & Address
Anthony Mullen, Special Education Teacher, The ARCH School, Greenwich High School, Greenwich, Connecticut

For full agenda, including workshops, visit www.nctr.org in July

Register and reserve hotel at www.nctr.org. Register by September 10 to a avoid late fee.

IN MEMORIAM

Iris Wolfson, staunch NCTR advocate and 17-year board member of the New York State Teachers' Retirement System (NYSTRS) passed away in June. Ms. Wolfson will be missed as chair and active member on NCTR's Resolutions Committee, as well as a long-time NYSTRS delegate at NCTR's annual business meetings. Ms. Wolfson served on diverse committees and as Vice President for the NYSTRS Board at the time of her death.

A graduate of New York University, Ms. Wolfson served the New York State School Boards Association for 30 years as treasurer and eight years as a director. She was past president of the Nassau-Suffolk School Boards Association and served in various capacities with schools and other education-related organizations. She also held posts with the National School Boards Association and was a member of the Council of Institutional Investors

NOTE THESE DATES

9th Annual
Trustee Workshop
Institute: July 27
Workshop: July 28–29
Hyatt Regency Newport
Newport, Rhode Island
REGISTRATION UNDERWAY

87th Annual Convention
October 10-15
Renaissance Esmeralda
Indian Wells, California
REGISTRATION UNDERWAY

NCTR Resolutions
ACCEPTED THROUGH AUGUST 31

Nominations for NCTR Executive Committee
ACCEPTED THROUGH SEPTEMBER 10