

Pension Funding Challenges

Pension Crisis and Impact on Public Pension Plans



Overview of Fiduciary Investment Advisors, LLC

- Fee-only independent registered investment advisory firm based in Windsor, CT
- 100% employee owned
- 30-person staff with considerable experience working together
- Over 100 institutions with more than \$10 billion of fiduciary assets
- We advise:
 - Municipal Retirement Plans (DB/DC)
 - Corporate Retirement Plans (DB/DC)
 - Not-for Profit Institutions (DC/Foundation/Endowment)
- We are not a broker or investment manager.

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“Public sector retirement costs pose a serious threat to state and local governments making pension reform a key factor in both future economic success for communities and quality of life for constituents” - Deloitte Touche

- ❑ Market crash of 2008 wiped out approximately a quarter of the value of a public fund investment portfolio – five years worth of investment results were lost
- ❑ Current pension crisis is a result of years of bad planning and poor policy decisions
- ❑ Strong market returns in 1990's and from 2003-'07 masked structural weakness: lack of funding prior to those periods - and greatly expanded benefits for retirees during those times – has pushed pension expenses much higher today
- ❑ Public plans deferred funding and failed to shore up revenues to finance pension funds – made possible by lack of prefunding requirements.

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Because of their very design, public pension plans put taxpayers on the hook for any deficit that can't be covered by investment gains

❑ Recession's Effect on Pension Funding

- ❑ *According to Wilshire Study, estimates for funding ratio for 125 state pension plans was 65% in 2009, down from estimated 85% in 2008.*
- ❑ *Pension Assets declined by 21.4% on average in 2008, while liabilities grew 5.6%.*

❑ **Public pension portfolios have, on average, 66.8% allocated to equities – including real estate and private equity – and a 33.2% allocation to fixed income – private sector pensions reducing equity exposure**

❑ **The median actuarial interest rate assumption is 8% - consensus market forecasts are for long-term median plan returns equal to 6.9% per annum.**

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An overview of U.S. Public and Private Defined Benefit Plans

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Comparison Item	Public Defined Benefit Pensions	Private Defined Benefit Pensions
Description	Pension plans sponsored by: federal, state, county, and municipal governments; school districts; certain other special-purpose entities	Any pension plan that files and IRS/DOL/PBGC Form 5500 (or equivalent) with the Internal Revenue Service in accordance with ERISA
Number of plans	Approximately 2,700 plans ¹	Approximately 48,000 plans ¹
Participants	Approximately 27 million ¹	Approximately 42 million ¹
Assets	Approximately \$4.1 trillion ²	approximately \$2.3 trillion ²
Percentage of workers covered by DB plan only	80% for state and local governments ³	10% for private-sector ³
Representative benefit	2% x final average pay x service ²	1.5% x final average pay x service ³
Benefit protection	Often constitutionally guaranteed (state-by-state basis)	Accrued benefits guaranteed: PBGC protects benefits up to center level
Cost of living adjustments	Common	Uncommon
Participant contributions	Typical	Not typical
Participant social security coverage	For state and local plans, coverage is state-specific (72% coverage ³)	Virtually all employees are covered: coverage percentage is 98% ³
Governance	Governed by state constitutional, statutory, and case law; exempt from many requirements of ERISA	Regulated at the federal level: U.S. Department of Treasury (under IRC), U.S. Department of labor (under ERISA)
Plan administration	For state and local plans, a board of trustees establishes an overall policy: which may include adopting actuarial assumptions, setting financial and reporting procedures and setting an investment policy. Financial reporting based on GAS accounting rules.	Trustees typically fund in accordance with the Pension Protection Act of 2006: plan financial and reporting typically based on FAS/IAS accounting procedures; trustees typically set an investment policy

Sources:

1. Employee Benefit Research Institute, Databook on Employee Benefits, 2007
2. Federal Reserve, *Flow of Funds Accounts of the United States*, 2007
3. Center for State & Local Government Excellence, *State and Local Pensions Are Different From Private Plans*, 2007

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Common misconceptions about public pension plan problems

- ❑ **Public pension plans need to invest more in equities to enhance returns**
 - Policy makers need to understand and balance risks – can the plan (ultimately, the taxpayers) afford the downside risk?

- ❑ **Deferring costs can mitigate fiscal pressures**
 - Change funding policy or actuarial assumptions
 - Adopt new asset class valuation measures
 - Alter actuarial funding methods
 - Short term thinking – quick fix but pattern usually results in long-term consequences

- ❑ **Defined contribution plans will fix the problem**
 - Won't resolve short-term pension fiscal problems
 - Phase in strategy – not likely to see any “pension relief” for 20-30 years

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States and towns may be forced to reduce benefits, raise taxes or slash government services to address a projected \$1 trillion funding shortfall

- ❑ **Lack of Prefunding Requirements**
 - ❑ **Generally no requirements forcing public plans to fund pension liabilities – by contrast, private sector must comply with ERISA**
 - ❑ **“Funding Holiday” - paying less than actuarially determined contribution each year increases the unfunded liability**
 - ❑ **Consequences: impact on debt ratings and possibility of higher contributions in the future**

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- ❑ **Benefit Enhancements & Supplemental Benefits**
 - ❑ **Expanded benefits for retirees – and easier to get**
 - ❑ **Supplemental plans greatly expanded over last 10 years**
 - ❑ **Safety-work classification broadened – qualifying for higher retirement benefits**
 - ❑ **Generous rules selling back unused sick and vacation time artificially raised finally year earnings – bigger lifetime pensions**

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- ❑ **Early Retirement Packages & Smaller Employee Contributions**
 - ❑ **Lucrative unreduced early retirement benefit provisions encouraged employees to retire in early 50s**
 - ❑ **Often designed without understanding total costs**
 - ❑ **Early benefit payout period and pensioner longevity results in a longer draw down of benefits**
 - ❑ **Employee contributions have not kept pace with the rise in plan costs**
 - ❑ **Burden of higher costs are forced upon taxpayers**

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- ❑ **Deferring Pension Contributions to Balance Budgets**
 - ❑ **Weaker economy results in lower government revenues**
 - ❑ **Diversion of retirement fund contributions to other priorities**
 - ❑ **Result, underfunded pension plans**
 - ❑ **Credit rating agencies are monitoring**

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- ❑ **Challenge of Modifying Public Plans**
 - ❑ **Often product of collective bargaining agreements – union protection and political sensitivity**
 - ❑ **Public pension plans have constitutional protection in some states**
 - ❑ **Private sector plans can reduce future benefit accruals and even freeze benefits “frozen plan”**
 - ❑ **Public plans can change or reduce benefits for employees not yet hired – bigger question today is can benefits be reduced for employees not yet retired?**

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Issues facing public plans are numerous and complex. Plan sponsors will need to make some hard choices

- ❑ Setting minimum contribution levels that are actuarial sound
- ❑ Reducing benefits (aligning cost-of-living adjustments with inflation; altering health care programs)
- ❑ Mitigate end-of-career pay raises and increasing the minimum retirement age
- ❑ Review investment policies – balance profit potential with ability to afford potential losses
- ❑ Find new revenues sources – pension obligation bonds; sale of unused property
- ❑ Making employees pay more into the system
- ❑ Align employee “entitlement” expectations with taxpayers ability to pay – not in Kansas anymore
- ❑ Consideration of defined contribution plan for long-term solution

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The Road to Recovery

- ❑ **Assess the Problem**
 - ❑ What are the real costs and how big is the problem?
 - ❑ Investment portfolio? Underfunding? Overly generous benefits?

- ❑ **Involve and educate parties of interest**
 - ❑ Collective discussion on issues with officials, business leaders, unions, etc.,
 - ❑ Educate taxpayers, employees, etc.,

- ❑ **Manage expectations**
 - ❑ Complex issues will take time to resolve
 - ❑ No magic solution – collective, multi step effort will be needed from all involved

Fiduciary Investment Advisors, LLC

Mark R. Wetzel *President*

Mark is President of Fiduciary Investment Advisors, LLC (FIA). Prior to founding FIA, he was a Senior Vice President and PRIME Consultant at UBS Financial Services Inc. He chaired their PRIME advisory committee and was a member of the firm's pension and 401k committee. He received a Bachelor of Science degree from the University of Vermont and a Masters of Business Administration from the Tuck Business School at Dartmouth College where he graduated as a Tuck scholar with distinction. Mark has completed the coursework necessary for the CIMA certification. He is a trustee of the Ellsworth Foundation, Chairman of the Board of McLean and a director of the Granby Land Trust. He is a member of the investment committee for the Ellsworth Foundation, McLean, The Northfield Mount Hermon School, Hartford Hospital, and Novartis Corporation.

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