Police & Public Plans

Defending Defined Benefit

National Association of Police Organizations
28th National Pension & Benefits Seminar
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4 Common Misconceptions

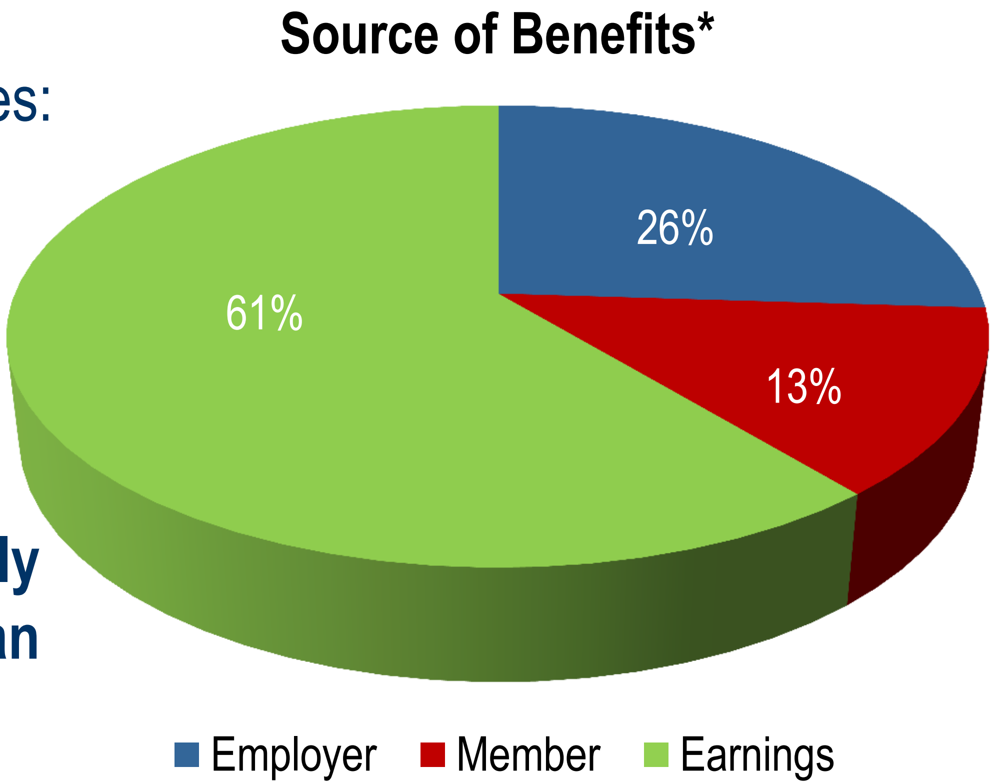
Misconception #1

Defined Benefit plans are more costly than Defined Contribution plans

Plan benefits come from three sources:

- ❖Member Contributions
- ❖Employer Contributions
- ❖Earnings

This is true for both DB and DC plans. Therefore, a DC plan will only cost less if it can out earn a DB plan



* *NASRA Issue Brief: Public Pension Plan Investment Return Assumptions*, National Association of State Retirement Administrators, April 2014

Misconception #1

Defined Benefit plans are more costly than Defined Contribution plans

The National Institute for Retirement Security*

"A typical DB plan provides equivalent retirement benefit at about the half the cost of a DC Plan, and 29 percent lower cost than an "ideal" DC plan modeled with generous assumptions"

Reason	%
Longevity risk pooling	15
Balanced portfolio and diversification	5
Superior investment returns	26

**Still a Better Bang for the Buck : An update on the Economic Efficiencies of Defined Benefit Pensions*, National Institute on Retirement Security, December 2014

Misconception #1

Defined Benefit plans are more costly than Defined Contribution plans

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

Returns compared from 1990-2012 , averaged 0.70% greater for DB plans over DC plans[1]

TOWERS WATSON

Pension plans often beat 401(k) plans. Since 1995, DB plans outperformed by 0.76% annually[2]

KEYSTONE RESEARCH CENTER

"How to Dig an Even Deeper Pension Hole"
reported that moving employees from DB to DC plans has ***failed in 3 states that have tried it*** *and was* ***rejected by 13 other states after research concluded that the change would hurt taxpayers and pension recipients[3]***

[1] *Investment Returns : Defined Benefit vs. Defined Contribution Plans,* Center for Retirement Research at Boston College, December 2015
[2] *Pension Plans Beat 401(k) Savers Silly – Here's Why*, Forbes, June 2013
[3] *How to Dig an Even Deeper Pension Hole*, Keystone Research Center, October 2014

Misconception #2

Public pension systems are grossly underfunded, liabilities significantly understated, and are unsustainable

- There are many different ways to measure a pension plan's liability. Some are appropriate for a public plan and others may not be.
- This means measuring based on an internal rate of return versus using external "shut down" measures
- Recent studies by NASRA show that the median public pension annualized investment returns have averaged 9.0% over the last 25 years, and that the average return assumption is 7.72%*
- New accounting standard "endorses" internal rate for plans using long term trust funding
- Using a rate that's too low would overstate the liability and could lead to excess assets, meaning taxpayers could be overtaxed

For funding purpose, we believe Police and other public plans should be measured on a long-term basis rather than the "shut down" basis that private plans are required to use.

*2014 Facts : State and Municipal Bankruptcy, National Association of State Retirement Administrators, 2014

Misconception #2

Public pension systems are grossly underfunded, liabilities significantly understated, and are unsustainable

Internal Rate of Return vs. "Shut Down" basis

	7.50%	4.50%
Current Asset Value	$72,000,000	$72,000,000
Accrued Liability	$72,000,000	$100,000,000
Funded Status	100%	72%
Potential Over Funding*	$ 0	$34,000,000

**10 year amortization cost of the potential overstatement of the liability*

Consider objective in defining perspective

Misconception #3

Police officers receive a very rich pension benefit

Average urban Police pension is about $46,400 per year*

- ❖For Police Officers not covered by Social Security, the pension must make up for Social Security
- ❖Typical Social Security benefit would be about $15,000
- ❖Member funds 1/3rd of their benefit

Source	Amount
Employer funded	$30,900
Member funded	$15,500

*Avg. for Chicago, Dallas, Detroit, Kansas City and Los Angeles – CNN Money 2013 http://money.cnn.com/2013/07/23/retirement/detroit-pensions/

Misconception #3

Police officers receive a very rich pension benefit

- Police Pension Plans operate as a controlled personnel management tool

- Police Pension Plans allow senior Police Officers to retire on their terms allowing for upward mobility for junior officers

Misconception #4

Public Pension Systems are a huge financial burden to communities

- DB pension plans act as an economic stabilizer - retirees with steady pension are willing to spend at local businesses – generating income and tax revenue
- Pension plans generate economic activity – a $1 in pension has been estimated to generate $1.98 in economic activity*
- Public pension plans are transparent under GASB accounting
- Studies show that pensions inure tangible economic benefits
- Amount of overall budget is not significant (under 3%)

*_NIRS Pension Economics 2014 – Measuring the Economic Impact of DB Pension Expenditures_, National Institute Retirement Security, 2014

Pension Reform and Design Best Practices

What is "Pension Reform"

- There has been a strong movement of late to change state and/or local laws to allow for alternatives to traditional Defined Benefit plans for providing retirement benefits

- In the past, changes in a pension design such as these focused on future hires rather than current members

- More and more, we are seeing these movements also targeting some (or all) of the current members

Illinois Pension Reform

Page: 1 2 3 4 5 >>

In Pension Battle, Governor Faces Constitutional Fight

Reuters | Posted 05.11.2015 | Politics

Read More: Reuters, Illinois Pension Battle, Bruce Rauner, Bruce Rauner Pension Battle, Illinois Pension, Illinois Pension Reform, Politics News

By Karen Pierog CHICAGO, May 10 (Reuters) - Illinois Governor Bruce Rauner faces a formidable challenge in his bid to reform public wo...

Read Whole Story

What is "Pension Reform"

OKLAHOMA PENSION REFORM: 401(K)-STYLE PLANS FOR NEW STATE WORKERS

PENSIONS / Article

May 31, 2014

In a step toward meaningful pension reform, Oklahoma Gov. Mary Fallin signed legislation that ends the state's traditional pension retirement system for newly hired state employees in favor of a 401(k)-style retirement plan. Teachers and state workers designated "hazardous duty" including firefighters and law enforcement officers are exempt. And the legislation does not change the...

In a step toward meaningful pension reform, Oklahoma Gov. Mary Fallin signed legislation that ends the state's traditional pension retirement system for newly hired state employees in favor of a 401(k)-style retirement plan.

PREVIOUS POST
ObamaCare Navigator Grants In Illinois
05/31/2014

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Daily Links For June 1
By Illinois Policy
06/01/2014

Big Picture — Defined Benefit versus Defined Contribution

- Many of the movements, like in Oklahoma, have been pushing for a Defined Contribution (DC) or 401(k) approach to replace the Defined Benefit (DB) approach
- Comparing the two types can be complicated

- Under a Defined Benefit Plan

Defined Employee Benefit → Plan Experience → Resulting Employer Contribution

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- Under a Defined Contribution Plan

Resulting Employee benefit ← Plan Experience ← Defined Employer Contribution

Key Features of Defined Benefit (DB) Plans

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- Predictable retirement income
- Design flexibility (early retirement subsidies, past service benefits, COLA, etc.)

−

- Often, low employee understanding and appreciation
- Actuarial valuations and financial reporting

Characteristics

- Single career focus
- Less portable
- Pooled assets
- Employer-managed assets
- Security focus
- Benefits older employees

Costs

- Can be more cost effective because of lower payouts to younger non-retirees
- Fixed obligation, not related to performance
- Unfunded liabilities
- Can be volatile

Key Features of Defined Contribution (DC) Plans

+

- Easy to understand
- Accessible to all employees
- High appreciation by younger employees

–

- Unpredictable retirement income
- Limited flexibility for ad hoc adjustments

<u>Characteristics</u>

- Multiple career focus
- Portable
- Member bears investment risk
- Member usually makes certain asset choices
- Value focus
- Benefits younger employees more than Defined Benefit plan

<u>Costs</u>

- Can be less cost efficient because of higher payouts to younger terminations
- Fully funded
- Can be made flexible or fixed
- Predictable

Pension Reform – A Case Study

- Following is a sample case study where we illustrate some of the potential "pitfalls" when comparing the two retirement delivery approaches
- This analysis was based on a state police Defined Benefit Plan
- The current plan provides a lifetime income of 70% Final Pay for anyone with 30 or more years of service
- Final Pay is final 12 months
- There is no post retirement cost of living increases on the 70%
- Members contribute 7.5% of their pay each year

Please note that in presenting this case study MassMutual is not advocating that Defined Benefit plans provide better benefits than Defined Contribution plans. We believe that either, when well-designed and well-managed, can produce favorable retirement results. We also believe that it's important for Plan Sponsors and Participants to be provided with the data and analysis needed to be informed decision makers about their retirement program and benefits.

The following analysis is for this specific plan and therefore results could differ depending on the actual plan and costs being analyzed.

Pension Reform – A Case Study

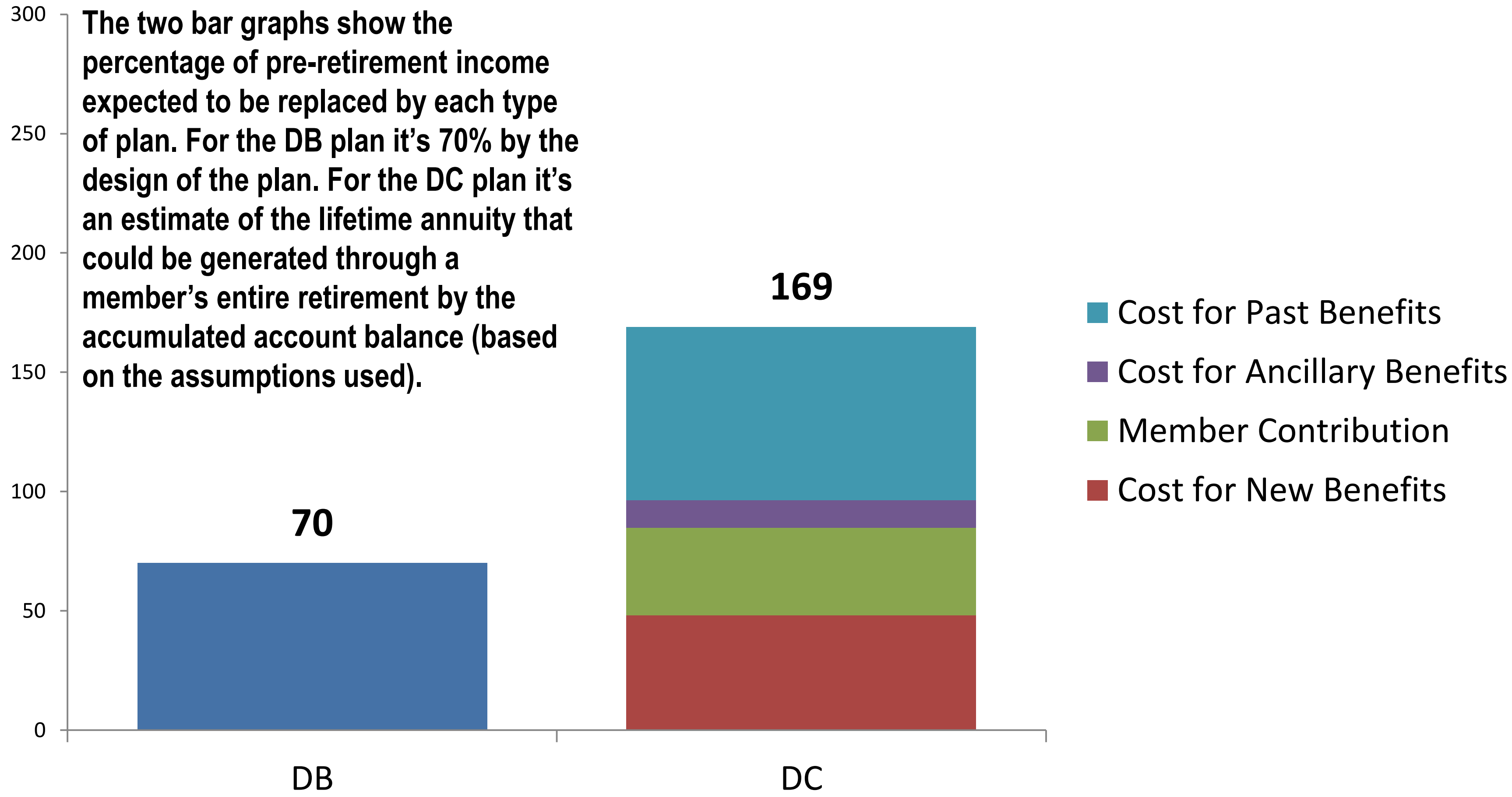
- The current recommended contribution as a % of payroll is:

Cost for unfunded past benefits	14.9%
Cost for current year's benefits (new)	9.9%
Cost for death and disability benefits (ancillary)	2.4%
Contribution from members for current benefits	7.5%
Total recommended contributions	34.7%

  - Assumed annual earnings (before and after retirement) on the pension trust assets 7.90%

Same Assumptions, All Contributions

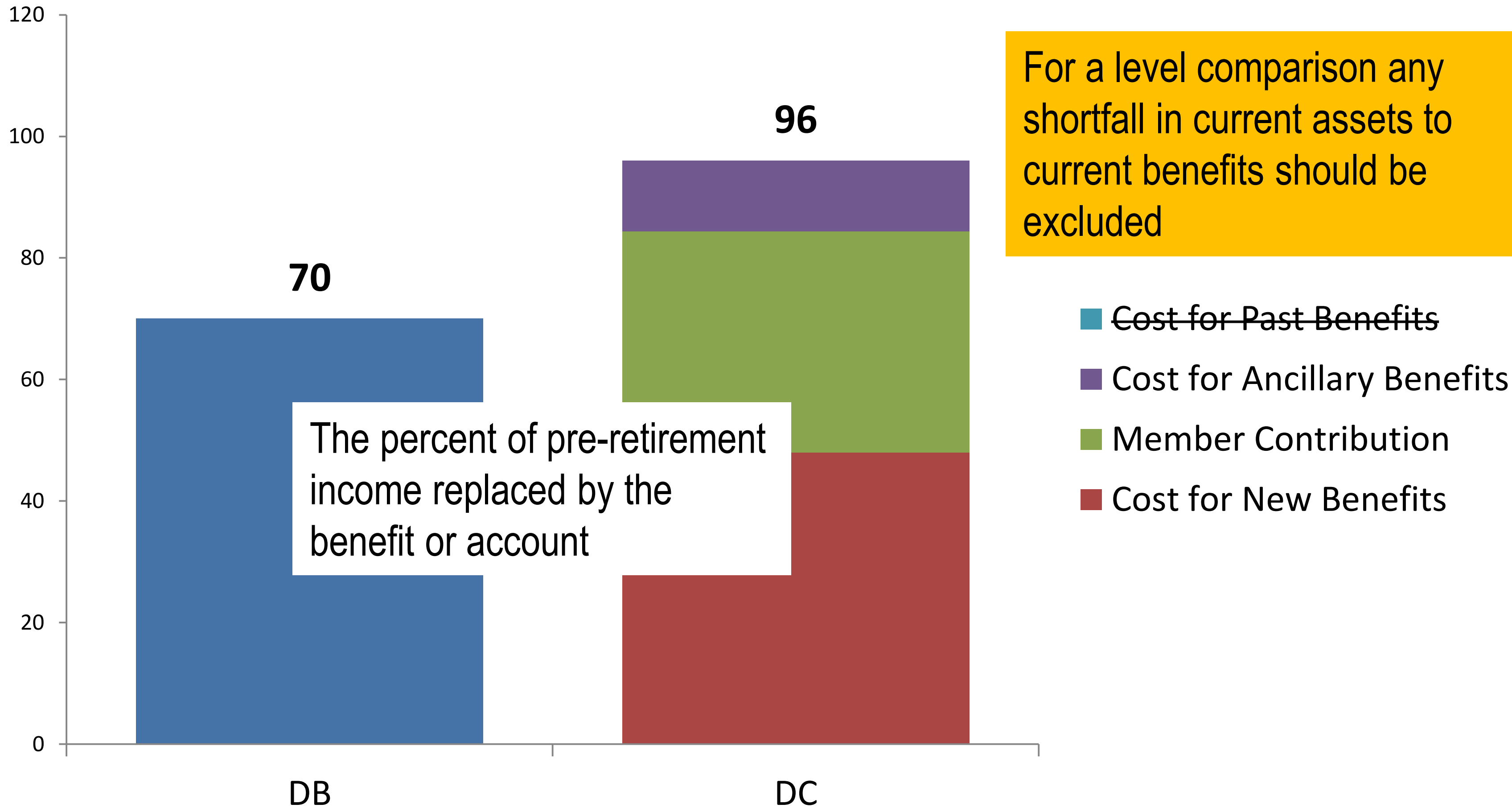
The two bar graphs show the percentage of pre-retirement income expected to be replaced by each type of plan. For the DB plan it's 70% by the design of the plan. For the DC plan it's an estimate of the lifetime annuity that could be generated through a member's entire retirement by the accumulated account balance (based on the assumptions used).



The comparison above is based on the entire 34.7% funded into the DC and the same 7.90% earnings before and during retirement*

** Hypothetical example, for illustrative purposes only. Not intended to reflect the actual performance of any specific investment. Individual experience will vary.*

Remove Cost for Unfunded Liabilities



For a level comparison any shortfall in current assets to current benefits should be excluded

The comparison above removes the 14.9% funding for past liabilities from the DC, same 7.90% earnings before and during retirement*

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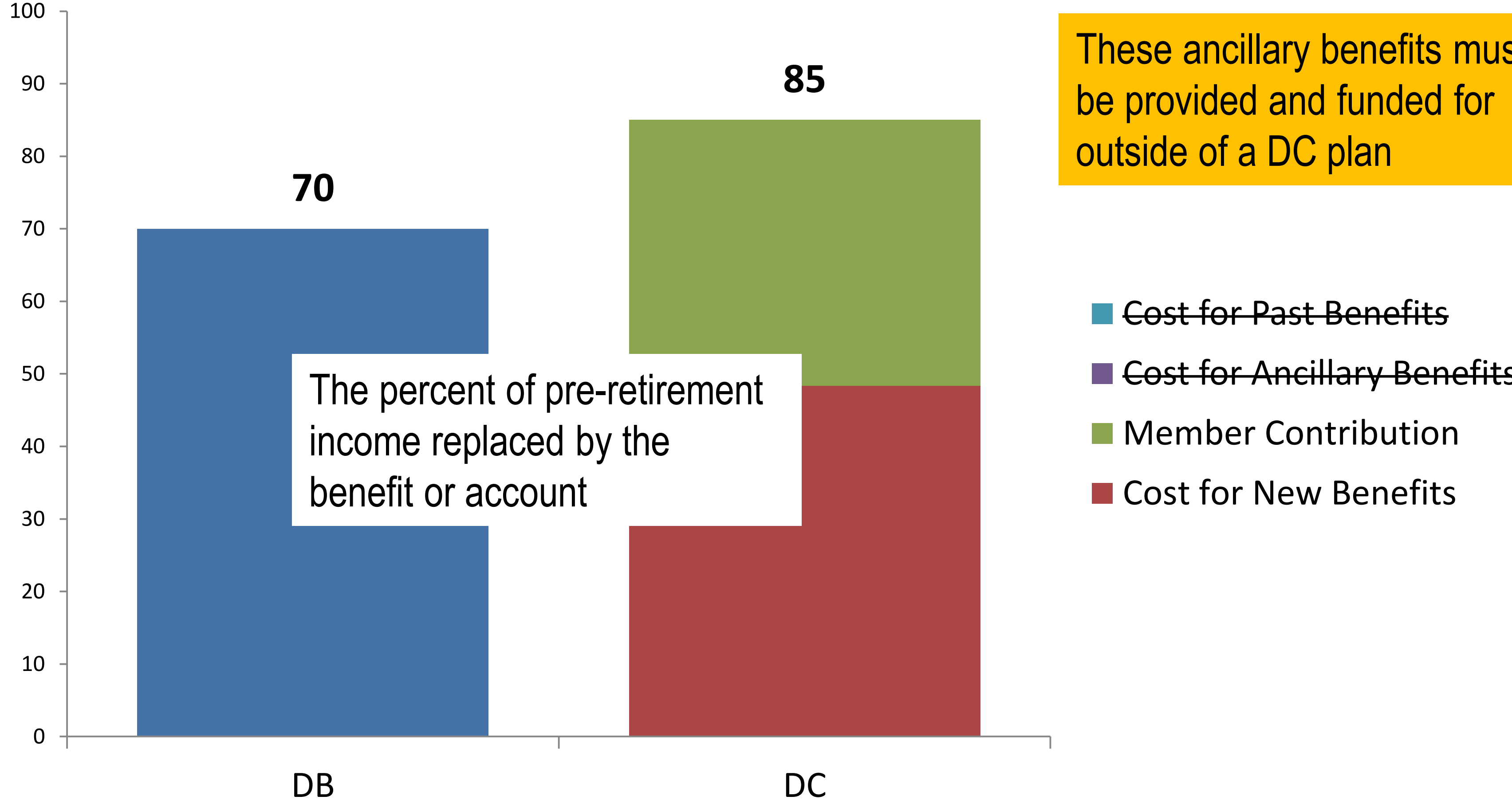
Remove “Insurance” Cost For Death & Disability

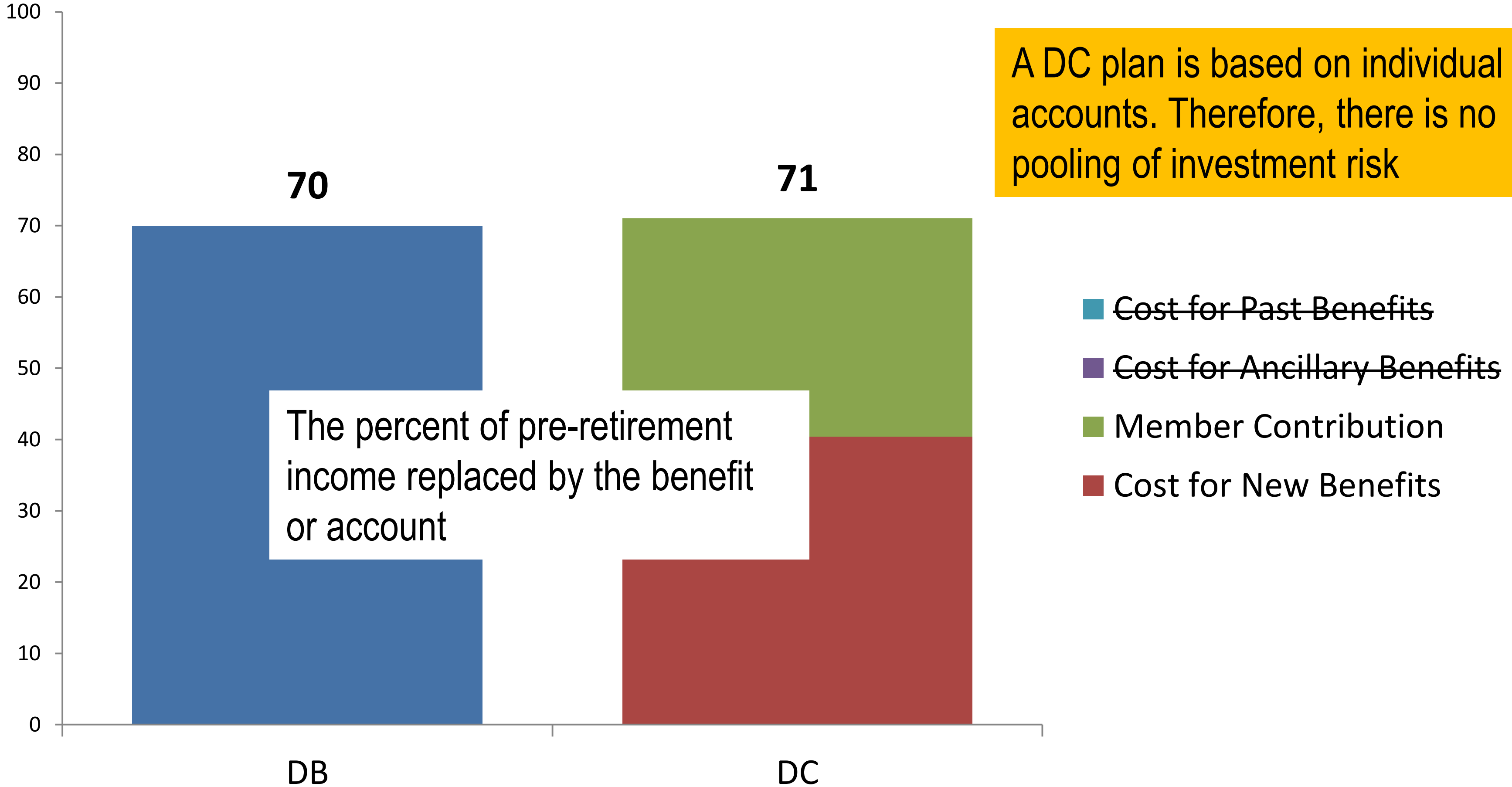
These ancillary benefits must be provided and funded for outside of a DC plan



This comparison also removes the 2.4% for active death and disability, same 7.90% earnings before and during retirement*

** Hypothetical example, for illustrative purposes only. Not intended to reflect the actual performance of any specific investment. Individual experience will vary.*

Adjust for Individual Earnings Expectations



The percent of pre-retirement income replaced by the benefit or account

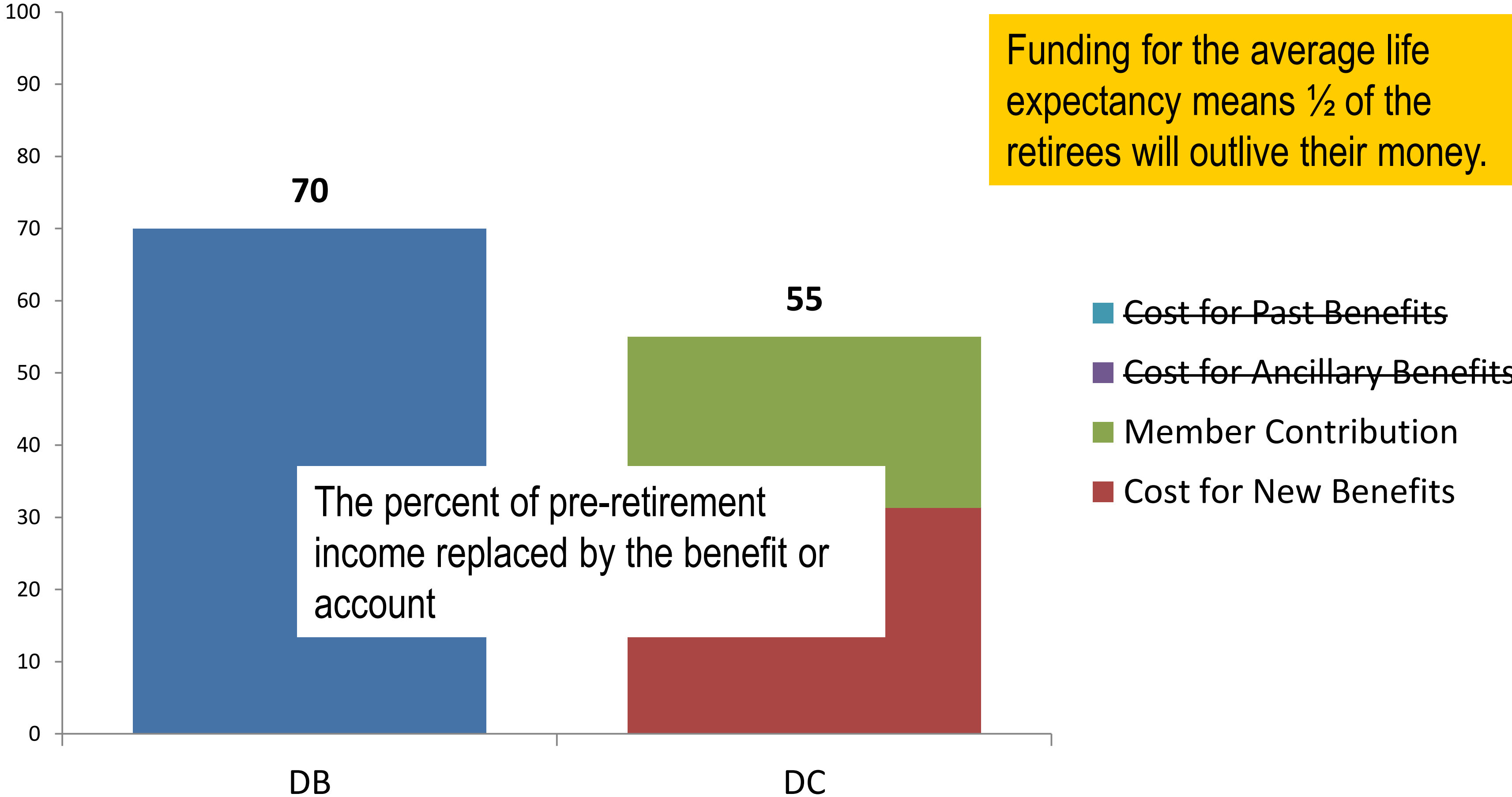
A DC plan is based on individual accounts. Therefore, there is no pooling of investment risk

Same combined (employer and member) contribution of 17.4%, but with 7.20% earnings before and during retirement*

** Hypothetical example, for illustrative purposes only. Not intended to reflect the actual performance of any specific investment. Individual experience will vary.*

Adjust for Full Longevity Protection

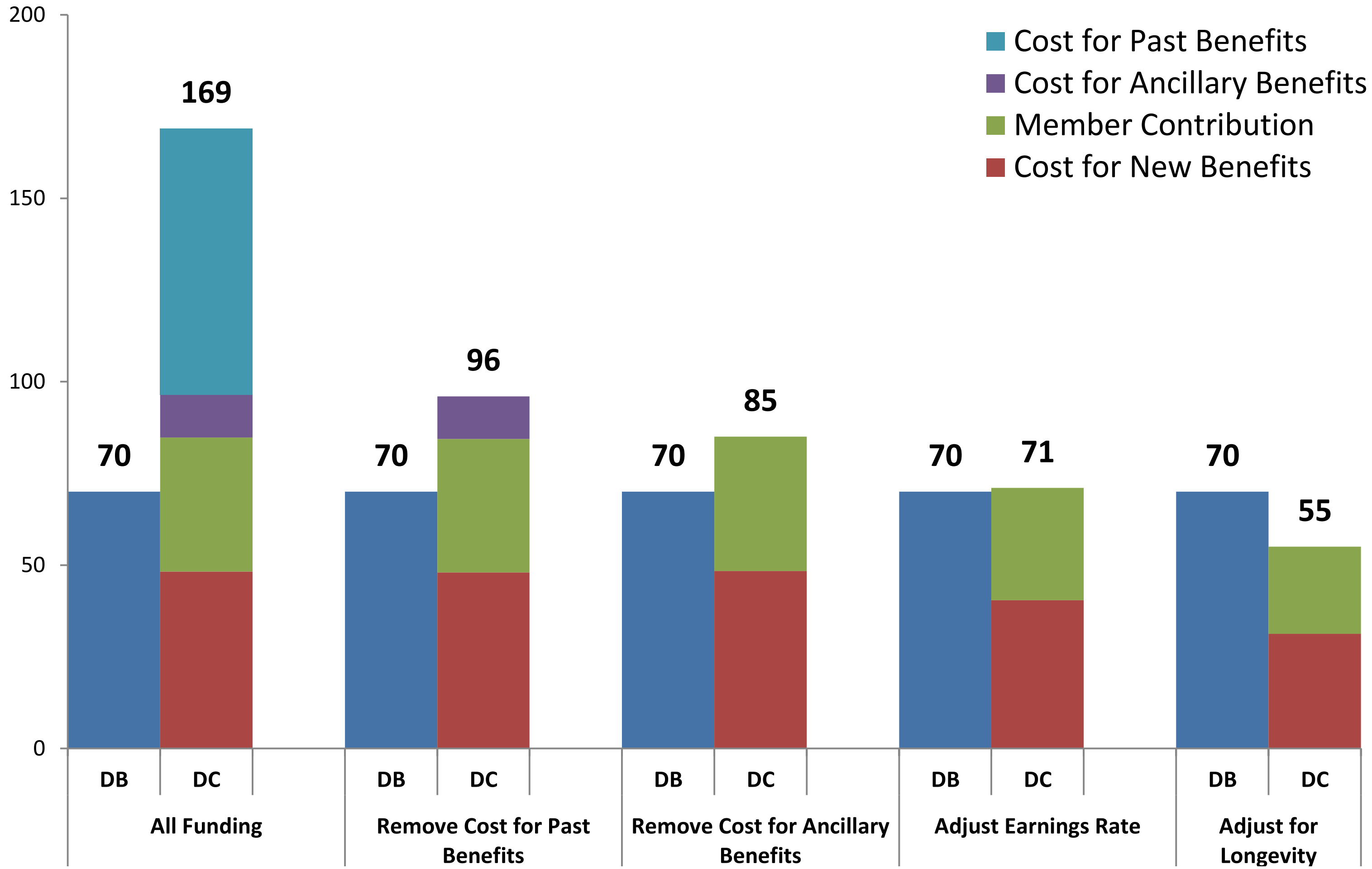
Funding for the average life expectancy means ½ of the retirees will outlive their money.



Same combined contribution of 17.4%, but with 7.20% earnings before and full longevity protection during retirement*

** Hypothetical example, for illustrative purposes only. Not intended to reflect the actual performance of any specific investment. Individual experience will vary.*

Summary*



*Summary of slides 20-24

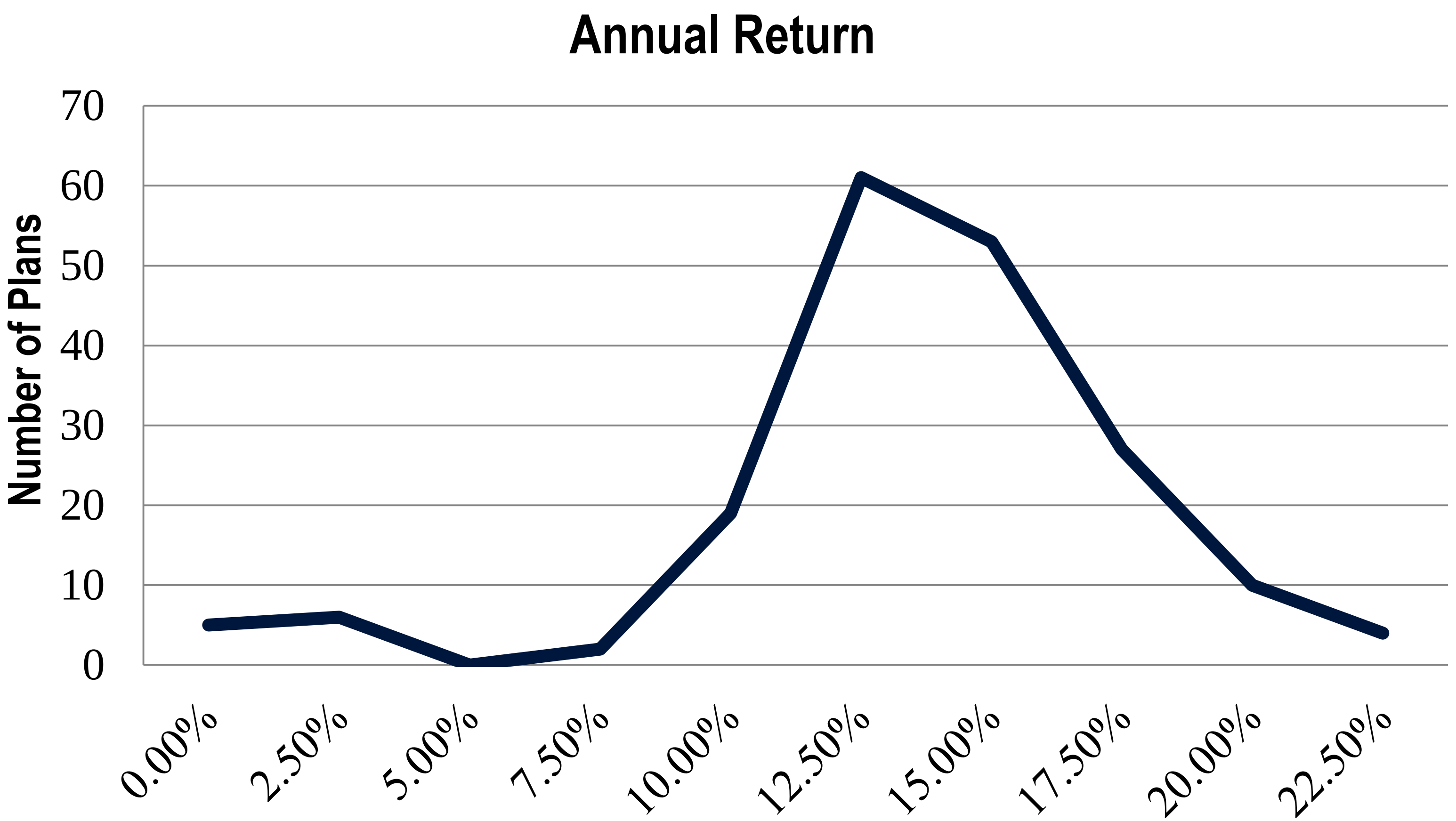
Summary of Police Plans – One State's Experience

- The state provides data summaries for municipal Defined Benefit plans
- Of 490 independent municipal plans, 187 cover Police
- Of those 187 plans, 92 cover employees not covered by Social Security
- Total assets $12.8 Billion
- Total Liabilities $17.9 Billion

Summary of Police Plans – One State's Experience

- The data shows a variety of funding levels, asset returns, and sizes
- Average Funded Ratio 81%
  - Median funded ratio is 79%
  - Shows that the state has as many well funded plans as poorly funded ones
  - 53 plans have a ratio higher than 90%
- Average return on assets 12.4%
  - Plans with funded ratio greater than 90% have an average return of 11.6%
  - Some correlation with funded ratio, but not completely
- Average participant count 257
  - Median participant count is 77
  - 17 Police Plans with 500 or more participants bring up the average
  - Size of plan has no bearing on how well funded

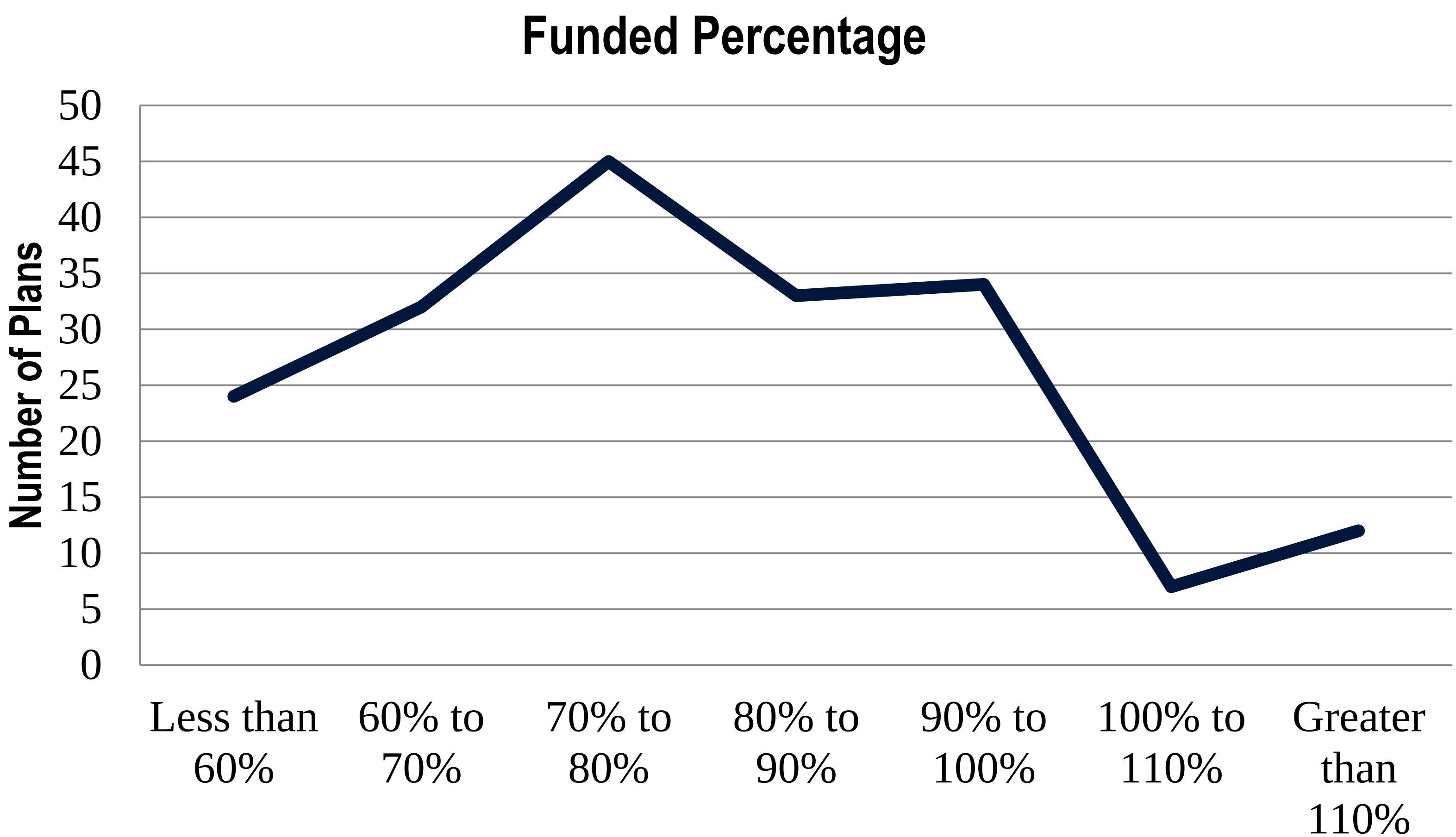
Summary of Police Plans – One State's Experience



Average annual return for 2014 is 12.4%*

*Department of Management Services' Division of Retirement 2015 Actuarial Summary Fact Sheets

Summary of Police Plans – One State's Experience



Average Funded Ratio for 2014 is 81%*

*Department of Management Services' Division of Retirement 2015 Actuarial Summary Fact Sheets

New Accounting Requirements

New GASB reporting rules

- GASB 67 Plan Accounting
  - Effective for FYs beginning after 6/15/2013 (replaces GASB 25)

- GASB 68 Sponsor Accounting
  - Effective for FYs beginning after 6/15/2014 (replaces GASB 27)

- At the heart of the new accounting rules is a separation of funding and accounting.

- Under the previous Standards an Annual Required Contribution (ARC) was calculated and many sponsors adopted this as a funding standard

New GASB reporting rules

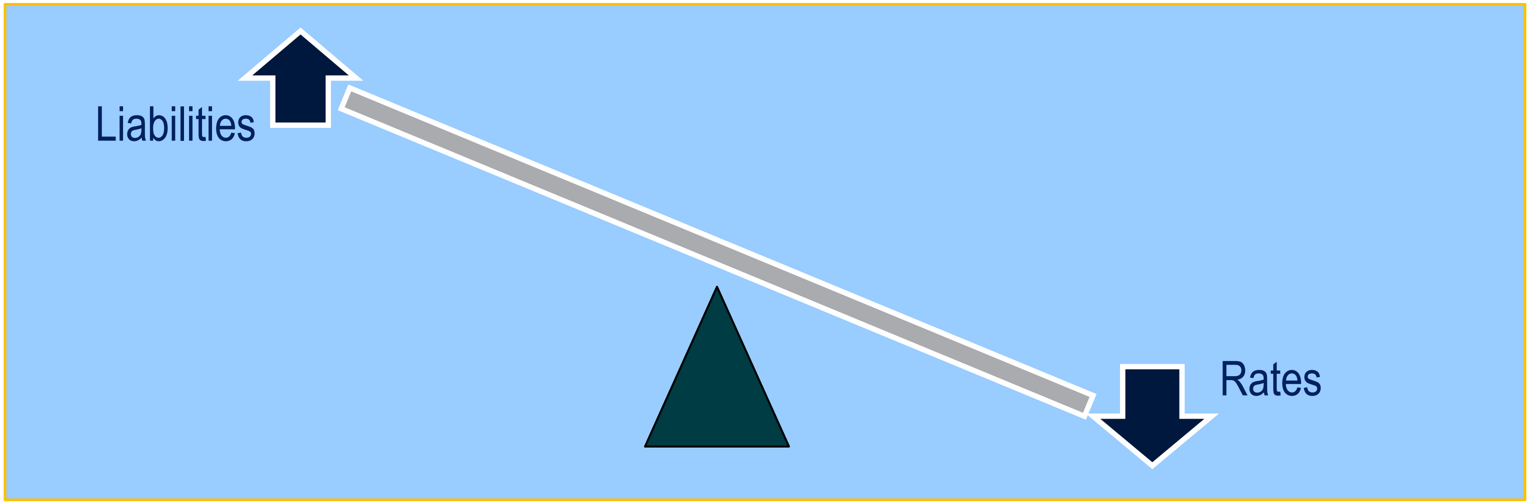
- Plans/sponsors were not required to contribute the ARC but there was an incentive to do so as any shortfall or excess contribution was accumulated and appeared in the notes to the financial statements.

- Under the new rules there is no ARC. This provides an opportunity to revisit and enhance understanding of what it means to fund defined benefit plans. The funding policy decisions remain with plan sponsors, retirement board systems, and legislative bodies.

- Under the new GASB rules there is a balance sheet liability and an income statement expense.
  - The balance sheet liability is the difference between the value of benefits and the value of assets.

New GASB reporting rules

- Discount Rate to Measure Liability = combination of expected Return on Assets & municipal bond rate
  - Previously the GASB 25/27 rate was based on the Expected Return on Assets
  - The lower the rate the higher the liability & expense



Using low rates for measuring liabilities results in high liabilities

New GASB reporting rules impact on funding

- Under GASB 67/68 the rate is the EROA only to the extent all future benefits are expected to be paid from invested assets
  - Those benefits that won't are discounted using a rate based on 20-year tax-exempt general obligation municipal bond
  - This "blended rate" will almost certainly be lower than the EROA and so result in higher accounting liabilities and accounting costs

	Using expected return on assets	Using a blended rate
Sample plan's GASB liability	$62M	$90M

Whether or not all future benefits can be expected to be paid from invested assets will depend on the current funding and investment policies

To avoid having to use a blended rate under GASB 67/68 it may be necessary to revisit and strengthen investment and funding policies

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