News Scan

GRS
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The following news summaries were developed by Gabriel, Roeder, Smith & Company to inform clients and other benefit professionals of news in the benefits industry. Our thanks to Mary Ann Vitale for her diligent work on this issue. To receive this publication electronically, send an email to web.admin@gabrielroeder.com with "SUBSCRIBE NEWS SCAN" in the subject line. To stop receiving this publication electronically, send "UNSUBSCRIBE NEWS SCAN" in the same manner. Copies of this and other benefit-related publications are available on the GRS web site at www.gabrielroeder.com.

Note: The authors of these summaries are not attorneys and the statements made are not legal advice or opinion. Qualified legal advice should be obtained before acting with regard to related laws and regulations.

NASRA/NCTR Release Issue Brief on Market Declines and Public Pensions

In December 2008, the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR) released an issue brief titled *Market Declines and Public Pensions*. The issue brief describes the effects of the current financial crisis on public pension plans. NASRA and NCTR explain that the financing objective of most governmental plans is to establish contribution rates that remain relatively level as a percentage of payroll over the long term. This promotes intergenerational equity by allocating the costs evenly across different generations of taxpayers.

Asset smoothing is essential to this strategy. Most public pension plans use actuarial smoothing to phase in investment gains and losses, typically over five years, which reduces the effects of shorter term financial market volatility. The brief indicates that due to actuarial smoothing (and other factors such as the timing of actuarial calculations and market gains and losses), the recent market decline will be recognized in government contribution rates more gradually than it would be otherwise. In this regard, asset smoothing acts as a form of financial shock absorber.

The issue brief also discusses public pension plans' prior experience with market turmoil. Although the scope and suddenness of the recent market decline may be unprecedented, the brief points out public pension plans have survived major market downturns in the past. Even taking into account the 1987 market crash, the 1990-91 recession, the bursting of the dot-com bubble, 9/11 and other events, through 2007 median public pension fund investment returns have been positive in 22 of the past 25 years. The brief notes "[e]ach time investment markets have declined, diversified and disciplined investors, including public pension funds, have been rewarded for their patient, long-term positions with strong subsequent investment returns."

In conclusion, the brief emphasizes that governmental plans with long-term, prudent investment strategies and funding mechanisms will not only have the liquidity to pay promised benefits in the short term, but also to accumulate assets and continue paying benefits responsibly over the long term.

The issue brief is accessible at: http://www.nasra.org/resources/NASRA_NCTR_ISSUE_BRIEF0812.pdf

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NCPERS Issues Position Paper on the Advantages of Using Conventional Actuarial Methods for Valuing Public Pension Plans

In November 2008, the National Conference on Public Employee Retirement Systems (NCPERS) published a position paper, developed with assistance from Paul Zorn at GRS titled, "The Advantages of Using Conventional Actuarial Approaches for Valuing Public Pension Plans." The paper compares conventional actuarial methods used for the majority of public plans with the "market value of liability" (MVL) approach advocated by certain financial economists. The paper argues that conventional approaches offer significant advantages over the MVL approach, by:

- Better reflecting the underlying nature of the governments that sponsor the plans;
- Better reflecting the underlying dynamics of public pension plans;
- Being more likely to provide for stable contribution rates;
- Being more likely to allocate pension costs equitably across current and future taxpayers; and
- Supporting better decisions related to public plan funding.

The paper concludes that the conventional methods for valuing public pension plan assets and liabilities are appropriate. Additionally, using new disclosures based on the MVL approach would likely be misleading and unnecessarily burdensome. While recognizing that public plans face challenges regarding plan funding, investment risks, and contribution volatility, the paper argues that changing the valuation method is unlikely to address these challenges. Rather, a better way is to address them directly. In particular, the brief suggests:

- Pension administrators and trustees should diversify their investments to better manage downside risk. Over the long term, if lower expected returns occur, they should be reflected in the actuarial assumptions under conventional actuarial methods.
- Governments and labor groups should realize that promised benefits based on plan overfunding will be difficult to sustain and, therefore, should work to ensure the benefits can be reasonably sustained over the long-term.
- Governments should recognize that contribution shortfalls will likely need to be paid in the future with interest. Additionally, taxpayers should help to monitor their governments to ensure that the actuarially determined contributions are made in a timely manner.

The paper is accessible at: http://www.ncpers.org/News/PageText/documents/ResearchSeriesIII.pdf

CRR Reports on the Impact of the Financial Crisis on Public-Sector Defined Benefit Plans

In November 2008, the Center for Retirement Research at Boston College released its report, *The Financial Crisis and State/Local Defined Benefit Plans.* As discussed in the report, the value of all retirement plan assets in the U.S totaled $15.3 trillion at the end of 2007, including assets of public- and private-sector defined benefit and defined contribution plans, and individual retirement accounts. Of this amount, the retirement assets of state and local government plans totaled $3.2 trillion, about 21% of total retirement assets. According to the report, the overall value of equities declined 42% from the market-peak on October 9, 2007, to October 9, 2008. For all retirement plans, the value of equity assets fell by $3.8 trillion during this period, including a $1.0 trillion decline in the value of equities for state and local government retirement plans.

The report also estimates the impact of this decline on the funding status of public plans, based on a sample of 120 state and local government plans with an average funded ratio of 87% in 2007. According to the report, if the sample plans funded ratios were based on the market value of assets as of October 9, 2008, the average funded ratios would have fallen to 65%. However, because many public sector plans smooth investment gains and losses into the actuarial value of plan assets over time (typically over a five-year period), the full impact of the financial crisis will be recognized gradually over time. As a result, the full impact of the financial crisis will depend on the future value of equities.

The report also discusses the different ways that the decline will affect state and local government plan participants and plan sponsors. Defined benefit plan participants are mostly protected from the effect of the financial crisis on retirement assets since plan sponsors bear the market risk. If equity values continue to remain low, states and localities will face increased pension contributions.

The brief is accessible at: http://crr.bc.edu/images/stories/Briefs/ib_8-19.pdf

GAO Encourages Wider Pension Coverage to Ensure Retirement Income Security

In November 2008, the U.S. Government Accountability Office (GAO) published a group of web pages under the heading: "2009 Congressional and Presidential Transition," intended to assist the new Congress and administration in developing public policy. The pages include one titled "Ensuring Retirement Income Security" which urges policymakers to consider how best to encourage wider pension coverage, adequate and secure pension benefits, and the role of tax preferences in retirement benefit provisions. The page also identifies the following problems that currently threaten retirement income security:

1) Total pension coverage accounts for only 50% of the total private-sector labor force despite tax incentives.
2) Plan sponsors continue to freeze or terminate their defined benefit plans which reduce future benefit accruals for affected workers.
3) Many workers choose not to participate in defined contribution pension plans, and those who do typically accumulate only small account balances.

The page provides links to two GAO studies that examine these issues in more detail, and calls on the U.S. Treasury to reassess the effectiveness and income distribution effects of relying on tax incentives to foster retirement security.

Further information is available at:
http://www.gao.gov/transition_2009/agency/dtr/ensuring-retirement-income-security.php

Brookings Institution Warns Social Security Debate on Individual Accounts Overlooks Investment Risk

On October 31, 2008, the Brookings Institute released its paper, *Stock Market Fluctuations and Retiree Incomes: An Update.* According to author Gary Burtless, Brookings Senior Fellow and former economist with the Department of Labor, advocates for including personal savings accounts in Social Security have ignored the financial market risk associated with such accounts. As discussed in the paper, the Social Security program provides workers with a reliable source of retirement income which is mostly protected against the risks of financial market volatility and company bankruptcy. Social Security accounts for about 40% of total retirement income for American workers over age 65, and even more for those in middle- and low-income families.

When investment returns were consistently high, personal savings accounts were attractive. However, when asset prices decline, the advantages of a government guaranteed pension are more apparent. The recent stock market decline illustrates the dramatic effect of lower asset prices on retirement savings. Between October 2007 and October 2008, U.S. stock market prices have fallen 43%. By comparison, the purchasing power of Social Security benefits has been unaffected by the stock market decline. The paper concludes that Social Security pensions have historically been more predictable and have served as a dependable foundation for basic retirement income.

The paper is accessible at:
http://www.brookings.edu/~/media/Files/rc/papers/2008/1031_market_burtless/1031_market_burtless.pdf