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GFOA Approves Best Practice on Sustainable Pension Benefit Tiers

In May 2011, the Government Finance Officers Association’s (GFOA) Executive Board approved a new Best Practice (BP) for state and local governments on *Designing and Implementing Sustainable Pension Benefit Tiers*. The GFOA regularly develops BPs to serve as guidance on selected topics. It also develops advisories to caution against certain practices.

In an effort to manage future costs and ensure sustainability of their pension plans, some governments are considering changing the structure of their pension benefits. One such approach would be to create a lower-cost pension benefit tier for new employees. The GFOA recommends that jurisdictions considering this approach should: (1) examine the government’s authority to revise its pension benefits; (2) identify its overall goals in doing so; (3) understand the effects of the change on the workforce; and (4) determine the financial impacts of the change on the government and its employees.

To analyze these issues, the GFOA recommends the following review process:

- Identify and address legal constraints;
- Identify financial sustainability goals;
- Review total compensation and the impact of pension benefit tiers;
- Investigate alternative plan design options; and
- Reconsider Other Postemployment Benefits (OPEBs).

As part of this process, the GFOA also recommends soliciting input from actuaries regarding forecasting benefit costs, determining funding adequacy, and making decisions regarding employer and employee contribution rates. In addition, jurisdictions considering new benefit tiers should understand the key plan design elements and how changes in these elements affect the benefits provided by the plan in relation to the financial goals of the government and its employees. The essential design elements include:

- **Retirement ages** – Given the extended retirement ages for full Social Security benefits, governments may want to consider recalibrating normal and early retirement ages.

- **Pension formula multipliers** – When establishing benefit multipliers, governments may want to consider all income that is expected to be paid to the member during retirement, including Social Security, Medicare, employer-provided retiree health care benefits, as well as personal savings.
- **Cost-of-living allowances (COLAs)** – If offered, COLAs should be actuarially funded to remain financially sound. If new benefit tiers are established, affordable COLA limits should provide sufficient inflation protection for retirees.
- **Employee contribution requirements** – If not currently required, governments may consider establishing employee contributions. If governments are creating new, lower benefit tiers for new employees, they may consider different contribution rates for existing and new employees to provide for more equitable treatment between the groups.
- **Benefit enhancements** – If governments establish new benefit tiers, they should clearly communicate their intent to make future changes only on a prospective basis in all policy statements and plan documents to avoid increasing pension liabilities through retroactive modifications.
- **Purchase of service credit** – If governments allow employees to purchase service credit in the new benefit tiers, they should ensure that the costs are based upon an actuarial valuation.
- **Anti-spiking provisions** – If governments establish new benefit tiers, they should consider provisions that exclude extraordinary income (e.g., lump sum payments for vacation, sick leave, overtime and compensatory time) from final average compensation calculations to avoid increasing retirement system liabilities for these payments.
- **Vesting periods** – If governments implement longer vesting periods for new hires, they should evaluate the impact on employee recruitment and retention.
- **Notice to employees and transition issues** – If changes are made to existing employees' pension benefits, governments need to provide ample time and sufficient notice for employees to adapt to the changes. Also, governments should clearly communicate how benefit tiers will apply to rehired or transferred employees.

The Best Practice on pension benefit tiers is at: http://www.gfoa.org/downloads/GFOA_BP_Newbenefittiers.pdf

The GFOA has separate best practices for *Essential Design Elements of Defined Benefit Retirement Plans*, *Essential Design Elements of Defined Contribution Retirement Plans*, and *Essential Design Elements of Hybrid Retirement Plans* at: http://www.gfoa.org/index.php?option=com_content&task=view&id=124&Itemid=136

NCPERS Releases Public Fund Study

On June 8, 2011, the National Conference on Public Employee Retirement Systems (NCPERS) released its 2011 Public Fund Study. Overall, the study indicates that the majority of the surveyed public pension funds are currently at sound funding levels, with some plans adopting substantial changes to ensure their long-term sustainability. Additionally, the study finds that the public pension funds are continuing to review and improve their business practices, communications, and oversight. Other key findings include:

- Although recent media coverage has focused on a small group of plans with funding challenges, most public pension funds are managed responsibly and maintain adequate funding levels. On average, public pensions are 76.1% funded and continue to work toward full funding. Among the respondents, the average overall funded status was 77.4% based on the plans' actuarial value of assets relative to total liabilities. The average period for amortizing unfunded actuarial accrued liabilities was 25.8 years.
- Public pension plans have been active in making changes to retirement benefits, plan design and actuarial assumptions in response to emerging political, economic and demographic factors. Some of the most common changes have been adopting longer periods for amortizing unfunded liabilities, lowering the actuarial assumed rate of return, raising age and service retirement eligibility requirements, and increasing employee contributions.

- Despite weak short-term investment experience in 2008 and 2009, the annual investment return for the most recently reported period averaged 13.5%. In addition, the 20-year average return was 8.2%. Overall the assumed rate of return on investments was 7.7%, and the assumed inflation rate was 3.5%. According to the study, 23% of the respondents have reduced their assumed rate of return over the past two years and an additional 15% plan to do so over the next two years.
- Investment returns are the single most significant source of plan funding. As reported, annual pension fund revenues are comprised of about 66% from investment returns, 24% from employer contributions, and 10% from employee contributions.

According to NCPERS's Executive Director and Counsel, Hank Kim, "the data we collected – the most current data available – tells a positive story." He added, "Public pensions are experiencing a robust recovery from the Great Recession and are reporting strong investment returns, growing assets and funding levels on track to meet their obligations. And they are actively making structural changes to respond to the current economic, political and social landscape." Additionally, he reported to BNA that, "What we can say anecdotally is that of all the factors that differentiate a plan that is well-funded versus a plan that has funding challenges, the biggest factor is whether the plan sponsors make their actuarially required contributions."

The survey was conducted by NCPERS and Cobalt Community Research based on responses from 215 public pension funds during March and April 2011. Of the respondents, 83% represented local pension funds and the remaining 17% represented state pension funds. The total assets of the pension funds exceeded \$900 billion and covered about 7.6 million active and retired public employees.

The survey is available at: http://www.ncpers.org/Files/2011_06_ncpers_public_fund_study.pdf

NIRS Releases Report on Lessons from Well-Funded Public Pension Plans

On June 29, 2011, the National Institute on Retirement Security (NIRS) released its report titled "Lessons from Well-Funded Public Pensions: An Analysis of Six Plans that Weathered the Financial Storm." The report analyzes the long-term funding practices of six well-funded public pension plans which have maintained a strong financial condition despite the economic crisis. The study examines each system's funding policy, benefit design and economic assumptions. The six state-level retirement systems represent a diverse group of public plans, which include: the Delaware State Employees' Pension Plan; Public Employee Retirement System of Idaho; Illinois Municipal Retirement Fund; New York State Teachers' Retirement System; North Carolina Teachers' and State Employees' Retirement System; and Teacher Retirement System of Texas.

Since 2000, the significant volatility in the financial markets has resulted in very low investment returns over the past 10-year period. Sound funding practices have helped to ensure the long-term affordability and sustainability of many public pension plans. The following key practices are identified in the paper as having helped the systems remain well-funded over this period:

- Employer pension contributions that have paid the full annual required contribution (ARC) and have maintained stability in the contribution rate at least equal to the normal cost;
- Employee contributions that have helped to share the pension plan cost;
- Benefit improvements that have been actuarially valued before adoption and properly funded after adoption;
- Cost-of-living adjustments (COLAs) that are granted responsibly;
- Anti-spiking measures that help ensure actuarial integrity and transparency; and
- Actuarial assumptions (including both inflation and the discount rate) that are reasonably expected to be achieved over the long term.

The report is available at: <http://www.nirsonline.org/index.php?option=content&task=view&id=613>

SLGE Releases State and Local Government Survey on Workforce Issues

In May 2011, the Center for State and Local Government Excellence (SLGE) published its survey report, “State and Local Government Workforce: 2011 Realities.” The electronic survey was recently conducted among members of the International Public Management Association for Human Resources (IPMA-HR) and the National Association of State Personnel Executives (NASPE). Of the 363 respondents who participated in the survey, 80% represented local governments, 14% represented state governments, and 6% represented the federal government or non-governmental sectors.

According to the survey, the most common workforce issues include: (1) retaining staff for core services; (2) reducing employee health care costs; and (3) addressing employee morale and workload problems. The respondents reported that 71% have reduced their workforce since the 2008 economic downturn and 25% reported that more employees are accelerating their retirement plans. Additionally, more than 70% of the respondents consider staff development to be a high priority for their workforce. The most common workforce changes include:

- 72% of respondents shifted more health care costs to employees
- 62% implemented a payroll freeze for current employees
- 54% established a hiring freeze for new employees
- 41% laid off workers
- 33% created wellness programs
- 23% transferred more health care costs to retirees
- 23% increased new employee contributions to pension plans
- 22% increased current employee contributions to pension plans

The respondents also reported that certain staff positions were difficult for them to fill, including: correctional officers, engineers, finance professionals, firefighters, information technology professionals, librarians, nurses, physicians, skilled trades (all types), social workers, police officers, police and emergency radio operators, and water treatment operators.

SLGE’s web site also quotes IPMA-HR’s Executive Director, Neil E. Richenberg, as stating: “The survey results confirm that the public sector continues to face extremely challenging times, with difficult workforce issues that need to be addressed. ... The actions taken by the public sector over the past several years to address budget gaps have resulted in a smaller workforce facing increased workloads. One of the key challenges for the public sector will be to remain an employer of choice that can compete for talent, especially in critical high skills areas.”

The survey report is available at: <http://tinyurl.com/2011realities>

Federal Reserve Reports Public Pension Assets Increased \$100B in the First Quarter of 2011

On June 9, 2011, the Board of Governors of the Federal Reserve released its *Flow of Funds* statistical report for the first quarter of 2011. On page 78, the report shows that state and local government employee retirement fund assets totaled \$3.03 trillion on March 31, 2011, up from \$2.93 trillion on December 31, 2010, an increase of \$100 billion (or 3.5%, based on the unrounded asset values). As compared to the recent low of \$2.17 trillion on March 31, 2009, total assets have increased \$860 billion (40%). In 2011, the state and local retirement funds’ holdings of corporate equities totaled \$1.86 trillion (61% of total assets) up from \$1.64 trillion (59% of total assets) a year earlier.

The *Flow of Funds* report is available at: <http://www.federalreserve.gov/releases/z1/current/z1.pdf>