News Scan
GRS
Gabriel Roeder Smith & Company
Consultants & Actuaries

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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.

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## NASRA/NCTR Release Public Fund Survey

In October 2007, the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR) released the Public Fund Survey *Summary of Findings for FY 2006*. The survey presents key data from 101 public retirement systems with 126 plans, covering 13.1 million active members, 6.3 million retirees and other annuitants, and holding $2.46 trillion in assets as of FY 06. The data pertain to defined benefit plans, including several hybrid plans. Overall, the systems surveyed represent approximately 85% of public retirement plan membership and assets.

The Summary of Findings presents statistical analysis regarding plan funding, membership, benefits, contribution rates, cash flows, and actuarial assumptions. Key findings include:

- The average actuarial funded ratio for the surveyed plans was 85.8% in FY 06, down slightly from 86.4% in FY 05, with three-fifths of the plans having funded ratios above 80.0%.
- The aggregate funding level declined slightly for the fifth consecutive fiscal year, but is projected to rise in FY 07 due to growth in assets that is expected to outpace growth in liabilities.
- Since FY 01, the number of annuitants has increased by a cumulative 22.5% compared with an increase in active members of only 4.2%. The ratio of active members to annuitants fell from 2.12 in FY 05 to 2.08 in FY 06.
- The median annual investment return was 17.6% in FY 06, up from 11.8% in FY 05.
- The median actuarial assumption for investment return was 8.0% in both FY 05 and FY 06. The median assumption for the real rate of return was 4.5% in both FY 05 and FY 06.

The survey results are available on-line individually for each system and plan, including: plan membership, actuarial assumptions and methods, plan assets and liabilities, contribution rates, and system asset allocations, among other information. Selected data can also be viewed through comparative tables that allow sorting on selected items and provide graphs of selected data (e.g., inflation and investment return assumptions).

The survey is available at: http://www.publicfundsurvey.org. Although registration is required to access the data, once the user is registered the data are available at no charge.


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## NCSL Reports on 2007 State Pension and Retirement Plan Legislation

In October 2007, the National Conference of State Legislatures (NCSL) issued its report on the major state pension and retirement plan legislation enacted in 2007. Prepared by Ronald Snell, director of NCSL's State Services Division, the report provides a comprehensive and detailed summary of enacted pension and retirement legislation. With regard to major issues, the long-term sustainability of defined benefit plans was a broad concern for state legislatures. The report found that none of the legislatures made major improvements to benefit packages in 2007, several states increased contributions, and two states passed rigorous legislation to improve the funded status of local government plans.

Other areas of concern included:

- Other post-employment benefits (OPEBs) as related to GASB Statements Nos. 43 and 45;
- Divestiture of investments, mainly from companies operating in Sudan;
- Forfeiture of retirement benefits; and
- Taxation of retirement income.

Other frequently addressed policy issues included benefit eligibility, contribution rates, funding issues, cost-of-living adjustments, governance and investment policy, health coverage, re-employment after retirement, and purchase of service credit. The report is organized by topics and summarizes the legislation enacted by state.

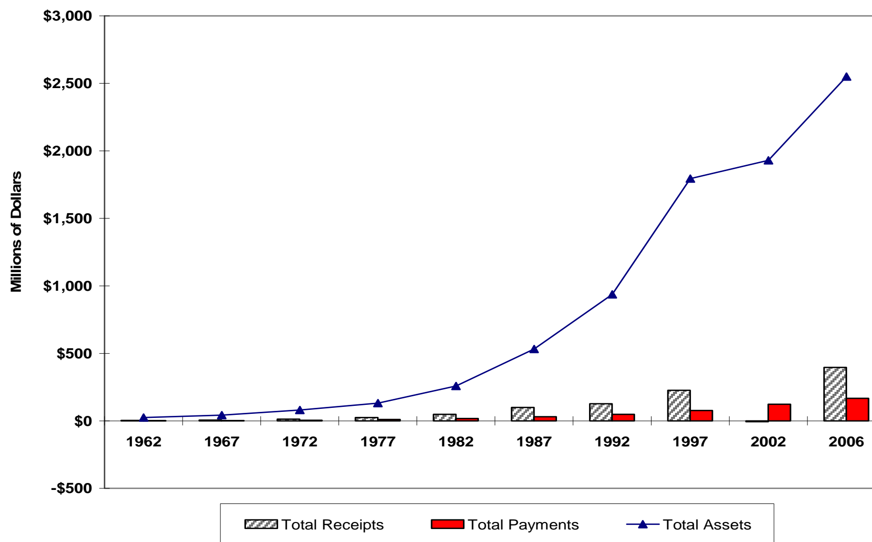
The information is available on the NCSL website at: http://www.ncsl.org/programs/fiscal/all_pensun.htm.

## U.S. Census Bureau Releases State and Local Government Retirement Systems Data

On September 28, 2007, the U.S. Census Bureau released the *State and Local Government Employee-Retirement Systems* survey data for fiscal year 2006. The annual survey covered 2,654 public employee retirement systems and includes data on revenues, expenditures, financial assets and membership for the retirement systems individually, as well as aggregated at the national and state levels. Highlights for fiscal year 2006 include:

- Total system revenues increased 12.2%, from $353 billion in FY 2005 to $396 billion in FY 2006. Revenues included $299 billion from investment earnings, $64 billion from employer contributions and $33 billion from employee contributions.
- Employer contributions increased 7.2%, from $60 billion in 2005 to $64 billion in 2006.
- Employee contributions increased 4.8%, from $32 billion in 2005 to $33 billion in 2006.
- Total system expenditures increased 6.4%, from $156 billion in 2005 to $166 billion in 2006. Expenditures included $151 billion in monthly benefit payments (up 7.1% from $142 billion in 2005), $5 billion in refund distributions, and $10 billion in other payments.
- Total annuitants receiving a regular benefit payment increased by 4.6%, from 6.95 million in 2005 to 7.27 million in 2006.
- Total active participants increased 2.1%, from 14.19 million in 2005 to 14.49 million in 2006.
- Average annual benefit payments increased 2.0%, from $20,463 in 2005 to $20,867 in 2006.

The following graph illustrates the trends in total receipts, payments, and assets for state and local retirement plans from 1962 through 2006. As shown, the most significant increase occurred between fiscal years 1987 and 2006 when total assets grew from $512 million to nearly $2.5 trillion. This was primarily the period during which public retirement systems increased the percent of assets held in equity securities. Also during that period, total receipts increased from $99 million to $396 billion, and total payments increased from $30 million to $166 billion.




Source: GRS Compilation of U.S. Census Bureau data

The Census Bureau cautions that because the data definitions used in the survey are different from those used for accounting purposes, the survey statistics cannot be directly equated to the systems' standard accounting statements. Moreover, the individual system data should not be used to draw inferences about the financial condition of specific public retirement systems or their sponsoring governments.

The 2006 census data can be accessed at: http://www.census.gov/govs/www/retire06.html

## GAO Releases Study on State and Local Government Retiree Benefits

On September 24, 2007, the U.S. Government Accountability Office (GAO) released its study titled *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs.* The report stems from a 2006 request by the U.S. Senate Finance Committee to provide an overview of state and local government retiree benefits with regard to both pensions and retiree health care.

For its report, the GAO examined retiree benefits and provided comparisons of typical differences between pensions and retiree health care regarding: 1) the types of benefits offered; 2) how benefits are protected and managed; and 3) how benefits are funded. The GAO also developed a model to simulate the fiscal outlook for the state and local governments as a whole, finding that:

- To meet estimated future pension costs (currently about 9% of payroll) would require an increase in annual government contribution rates of less than 0.5%, and
- To meet estimated future retiree health care costs (currently about 2% of payroll) would require contributions to more than double by the year 2050 (if they continue to be funded on a pay-as-you-go basis).

Since these estimates are very sensitive to assumed rates of return and projected rates of health care inflation, the funding requirements could be significantly different if the rates were to change.

The study also found that, generally, governments have established strategies to manage future pension costs. However, due to newly issued governmental accounting standards under GASB Statement No. 45, many are only beginning to establish strategies to manage escalating retiree health care costs. The report concludes that,

in the future, the fiscal outlook for retiree benefits will depend on the decisions of policy makers, voters and beneficiaries with regard to controlling costs, determining the appropriate level of benefits, and resolving how to share the costs for health care.

The report is available at: http://www.gao.gov/docsearch/abstract.php?rptno=GAO-07-1156

### SSA Releases 2007 Fast Facts and Figures about Social Security

In September 2007, the U.S. Social Security Administration's (SSA) Office of Policy released *Fast Facts & Figures about Social Security, 2007.* The publication answers frequently asked questions about the programs administered by the SSA and focuses on data for Social Security retirement, survivors, and disability benefits and Supplemental Security Income (SSI). Most of the data are derived from the *Annual Statistical Supplement to the Social Security Bulletin* and the *2007 Trustees Report*. Some of the highlights include:

- Overall, about 54 million people received SSA's benefits or assistance in 2006, with benefits averaging about $1,044 per month for retired workers, $978 per month for disabled workers, and $1,008 per month for (non-disabled) widow(er)s.
- In 2005, SSA paid benefits to 16% of the U.S. population and 90% of the population over age 65.
- About 65% of the population over age 65 received at least 50% of their income through SSA payments and 34% received almost all of their income through SSA payments.
- About 56% of the adult SSA benefits were paid to women.

The publication also provides the gradual extended ages for full Social Security retirement benefits based on year of birth, as shown in the following table:

| **Ages for Full Social Security Retirement Benefit** | |
|---|---|
| **Year of Birth** | **Full Retirement Age** |
| 1937 and earlier | 65 years |
| 1938 | 65 years 2 months |
| 1939 | 65 years 4 months |
| 1940 | 65 years 6 months |
| 1941 | 65 years 8 months |
| 1942 | 65 years 10 months |
| 1943-1954 | 66 years |
| 1955 | 66 years 2 months |
| 1956 | 66 years 4 months |
| 1957 | 66 years 6 months |
| 1958 | 66 years 8 months |
| 1959 | 66 years 10 months |
| 1960 and later | 67 |

The report is available at: http://www.socialsecurity.gov/policy/docs/chartbooks/fast_facts/2007/index.html. It includes links to the *Annual Statistical Supplement to the Social Security Bulletin* and the *2007 Trustees Report*.

### U.S. Treasury Department Releases Issue Brief on Framework for Social Security Reform

On October 12, 2007, the U.S. Treasury Department issued the second in a series of issue briefs on Social Security reform titled *Social Security Reform: A Framework for Analysis.* The brief discusses four key questions intended to aid policy makers in establishing an analytical framework for designing, debating and evaluating Social Security reform plans. The brief focuses on safeguarding Social Security surpluses to help ensure benefit adequacy and fairness across generations.

According to the brief, the key questions that should be addressed include:

1) How should the burden of the changes required to make Social Security solvent be distributed across generations?
2) How should Social Security's benefits and taxes be distributed across people within each generation?
3) How large should Social Security's benefits be?
4) Are enough Social Security surpluses set aside to help pay future Social Security benefits?

As the basis for measuring the impact of reform, the report proposes using a "lifetime net benefit rate," defined as net lifetime Social Security benefits (i.e., benefits minus taxes) as a percentage of an individual's lifetime wages (with benefits and wages expressed as present values using risk-free bond discount rates). This is intended to summarize the difference between the Social Security benefits received in retirement and the taxes paid into the system. Under this approach, a negative net benefit rate is effectively a tax rate (e.g., a net benefit rate of -3% would mean that for every $100 in wages, $3 was being used by Social Security to finance benefits promised or paid to earlier participants). This measure can be extended to groups of individuals in order to measure the impact of reform across and within generations.

According to the brief, contributions to Social Security can generally be seen as consisting of two parts: (1) a "net tax" component allocated to make the system permanently solvent and (2) a "forced saving" component that funds retirement benefits. For example, with a payroll tax rate of 12.4% and benefits with a present value equal to 8.4% of wages, the net tax equals 4% of wages while forced saving is 8.4% of wages. In this case, under the forced saving component, Social Security is acting like a savings account receiving 8.4% of wages per working year which determines the level of retirement benefits. Therefore, any increase in the forced saving amount implies a corresponding increase in the amount of attempted prefunding of Social Security benefits.

Although the brief presents a conceptual framework for evaluating the tax impact of reforms on different generations, it does not present measures for assessing the fairness and benefit adequacy of the reforms. Nor does it explore alternative mechanisms for ensuring that prefunding Social Security results in additional resources to finance future benefits. These issues will be addressed in future papers.

The issue brief is available at: http://www.treas.gov/press/releases/reports/treasssissuebriefno2.pdf

### Center for Retirement Research Analyzes Impact of Rising Medicare Costs on Retirement Security

In October 2007, the Center for Retirement Research (CRR) at Boston College released an issue brief titled *Medicare Costs and Retirement Security*. The brief focuses on the Medicare program and discusses the impact on future retirees of rising out-of-pocket payments and higher taxes, which will be necessary to cover future health care expenditures. The brief also compares the dramatic differences between future retiree health care costs and future Social Security benefits.

According to CRR, the costs of Social Security, Medicare and Medicaid are expected to grow significantly with total expenditures projected to increase from 9% of Gross Domestic Product (GDP) in 2007 to 24% in 2080. While, Social Security's rising costs are solely due to the aging of the population, Medicare and Medicaid's costs are not only due to the aging of the population, but more importantly to health care inflation and the increasing volume and intensity of services. The issue brief also explains the composition of Medicare's two programs as follows:

1) Hospital Insurance (HI) Trust Fund that pays for inpatient hospital services, skilled nursing facilities, and home health care under Part A. HI is financed by a 2.9% payroll tax paid equally by employers and employees.

2) Supplementary Medical Insurance (SMI) that consists of two separate accounts: i) Part B that covers physician and outpatient hospital services and ii) Part D that covers prescription drugs. SMI is financed by about 75% from the government's general revenues, such as personal and corporate income taxes, and about 25% from monthly premiums charged to beneficiaries.

In the future, both HI and SMI will require additional funds. However, funds to finance HI will likely be derived from worker's payroll taxes; whereas, financing SMI will be derived from income taxes paid by workers and retirees. Currently, the government's general revenue contribution to SMI equals 1.3% of GDP; however, it is expected to rise to 3.4% by 2040, and 4.7% by 2080. If all other elements remain constant, increasing SMI costs would require workers and retirees to face an 18.5% increase in income tax rates in 2040, and a 30% increase by 2080.

Additionally, future retirees will also face higher SMI out-of-pocket expenditures for premiums, deductibles and copayments. In 2007, SMI's average out-of-pocket expenses are 29% of the average Social Security benefit. By 2040, SMI out-of-pocket expenses will rise to 53% of the average Social Security benefit, and by 2080 will reach 73% of the average benefit.

The CRR authors indicate that a long-term solution should not only control costs for Medicare, but also the entire health care system. However, since health care reform will not likely occur soon, they advise those approaching retirement to prepare for costly health care expenses.

The issue brief is available at: http://crr.bc.edu/images/stories/Briefs/ib_7-14.pdf

### Kaiser Family Foundation Publishes Fact Sheet on Trends in Health Care Costs and Spending

In September 2007, the Kaiser Family Foundation released a fact sheet titled "Trends in Health Care Costs and Spending." The study presents key statistics on health care costs related to the level, growth, and impact of U.S. health care costs. It also covers health care spending on various medical services, sources of health care spending, employer-sponsored health coverage, and the impact on U.S. businesses and individuals. Key facts regarding U.S. health care include:

- **Overall health care spending** – In 2007, overall health care spending is projected to be over $2.2 trillion ($7,500 per resident) and is estimated to increase to $4.1 trillion by 2016 ($12,782 per resident). Health care spending is projected to rise from 16.2% of Gross Domestic Product (GDP) in 2007 to 19.6% by 2016.
- **Distribution of health expenditures -** Over 50% of health care expenditures is attributable to hospital and physician/clinical services, 10% to prescription drugs, 16% to other health spending (i.e., administration, research, equipment, etc), 13% to other personal health care (i.e., dental and other professional health care services, durable medical equipment, etc.), and nearly 9% to nursing and home health care.
- **Spending on health services -** About 10% of the population accounts for over 60% of spending and 1% of the population accounts for 20% of spending. The 50% of the population with the lowest health spending accounts for about 3%.
- **Sources of health spending** – In 2005, about 55% of total health spending is through private health insurance and the remaining 45% is through public programs, such as Medicare. By 2016, private spending is projected to fall to 51% while public spending will grow to 49%, primarily due to the growth in Medicare's spending resulting from implementation of the Medicare Prescription Drug benefit.
- **Impact on businesses and individuals** – Between 2002 and 2007, the cumulative growth in health insurance premiums was 78%, compared with cumulative inflation of 17% and cumulative wage

growth of 19%. In 2003, almost 20% of non-elderly individuals were in families with health care spending for premiums and cost-sharing exceeding 10% of family income.

The fact sheet can be accessed at: http://www.kff.org/insurance/upload/7692.pdf

### U.S. Supreme Court Agrees to Review EEOC's ADEA Lawsuit Against Kentucky Retirement Systems

On September 25, 2007, the U.S. Supreme Court agreed to consider whether any use of age as a factor in a retirement plan is "arbitrary" and thus facially discriminatory in violation of the Age Discrimination in Employment Act (*Kentucky Retirement Systems v. EEOC*, U.S., No. 06-1037). The case stems from an age discrimination claim filed by a deputy sheriff in Jefferson County. Upon applying for disability benefits from the Kentucky Retirement Systems (KRS), the deputy was informed that, while he was eligible for normal retirement benefits, he was ineligible for disability benefits because he was older than the plan's normal retirement age.

Under the plan's provisions, employees who become disabled after normal retirement eligibility (i.e., age 55 for workers in hazardous positions and age 65 for other workers) receive normal retirement benefits based on actual years of service. However, those who are disabled before normal retirement eligibility receive additional years of service credit up to the lesser of normal retirement age or 20 years of service, but not more than the number of years already worked. As a result, younger workers who are disabled before becoming eligible for normal retirement can receive higher benefits than older workers who are eligible for normal retirement, even with the same final earnings and actual years of service.

In 1999, after investigating the deputy's claims, the EEOC filed suit in the U.S. District Court for the Western District of Kentucky. In 2003, the district court ruled in favor of KRS, holding that the EEOC had failed to show how the plan's age elements were discriminatory. The EEOC appealed to the U.S. Sixth Circuit Court of Appeals, where a panel of three judges affirmed the district court's opinion in 2005. In 2006, the EEOC again appealed to the Sixth Circuit, requesting a hearing by all 14 of the court's appellate judges.

The full appellate court found the plan "facially discriminatory" in two ways. First, the plan disqualifies employees from receiving disability retirement benefits if they have reached normal retirement age at the time they become disabled. Second, the plan calculates disability retirement benefits using a method that results in an older employee receiving lower monthly benefits than a younger employee who is similar in every applicable factor other than age. The appellate court also ruled that, because the plan was facially discriminatory, it was not necessary for the EEOC to show discriminatory intent to establish an age-discrimination claim.

The petition to the U.S. Supreme Court was filed by the Kentucky Retirement Systems, the state of Kentucky, and the Jefferson County Sheriff's Department requesting the Court to review the U.S. Sixth Circuit Court of Appeals' decision. The petitioners argued that, by granting the petition, the Court would be able to provide much needed guidance regarding the use of age in retirement plan provisions. The Court granted the petition and oral arguments are scheduled for early 2008.

Source: BNA, *Pensions & Benefits Reporter*, October 2, 2007.

### IRS Releases New "Three Segment" Rates for Minimum Funding and Lump Sum Calculations

On October 10, 2007, the IRS issued Notice 2007-82, presenting new "three segment" interest rates for determining minimum funding requirements and minimum lump sum distributions for private-sector defined benefit plans. The segment rates result from changes made by the 2006 Pension Protection Act. For the most part, the new rates do not apply to governmental plans, although certain segment rates are to be used by governmental plans in conjunction with testing benefits under the IRC §415(b) benefit limits.

**Minimum Funding Rules.** Currently for minimum funding purposes, private-sector retirement plans calculate their current liabilities using an interest rate that can range between 90% and 100% of the weighted average interest rate on long-term, investment-grade corporate bonds. For plan years beginning in October 2007, this corporate bond weighted average is 5.88% with a permissible minimum of 5.29% (i.e., 90% of 5.88%).

The 2006 Pension Protection Act significantly changed minimum funding rules for single-employer private-sector plans for plan years beginning on or after January 1, 2008. As provided in newly added IRC § 430, a plan's funding target will generally be determined using the present value of all benefits accrued or earned under the plan as of the beginning of the plan year. Calculation of this present value is determined using the new three segment rates which apply to cash flows during specific periods. The first segment applies to cash flows during the first 5 years, the second to cash flows between 5 and 20 years, and the third to cash flows after 20 years.

The IRS calculates the segment rates using a complicated method that imputes interest rates to a hypothetical yield curve extending 100 years, based on 24-month average rates on corporate bonds with credit ratings of A or higher. The hypothetical rates are then averaged within the segment periods to obtain the segment rates. For October 2007, the first, second, and third segment rates are 5.29%, 5.86% and 6.40%, respectively. The PPA also allows private plans to transition to the new rates over a three-year period in a manner that blends the current rates with the segment rates. For plans in existence prior to 2008, the transitional rules apply for plan years beginning in 2008 and 2009. For October 2007, the "transitional" first, second, and third segments rates are 5.68%, 5.87% and 6.05%, respectively.

**Minimum Lump Sum Rates.** IRC § 417(e)(3) establishes the interest rate and mortality table used for determining minimum lump sum distributions for private-sector plans. Currently, this rate is based on the 30-year Treasury rate which, for August 2007, is 4.93%. However, the PPA changed IRC § 417(e)(3), such that for plan years beginning after December 31, 2007, the three segment rates (with certain adjustments) will be used for determining minimum lump sum distributions. However, the transition will take place over a five year period (rather than three years under the minimum funding rules). The first, second, and third "minimum present value transitional segment rates" for August 2007 are 5.02%, 5.18%, and 5.28%, respectively.

**Application to Governmental Plans.** Although governmental plans are not required to use the 417(e)(3) rates for determining minimum lump sum distributions, the final 415 regulations require governments to apply the 417(e)(3) rates when adjusting certain benefits for testing under IRC § 415(b). Specifically, the new 417(e)(3) segment rates will be used when adjusting lump sum distributions, period certain only distributions, and other distributions with a decreasing payment pattern. In addition, the segment rates will be used when determining the actuarially equivalent value of after-tax employee contributions.

For lump sum calculations, the segment rates are applied to each participant's projected benefit payouts. Therefore, the effect on lump sum payments will vary by participant. Generally, the change will likely mean a slightly higher value of the benefit tested against the 415(b) limit when all or a portion of the benefit is provided as a lump sum (or partial lump sum) distribution or as a period certain annuity. It might also mean a slightly lower benefit tested against the 415(b) limit where employees make mandatory after-tax employee contributions to the plan. However, the overall impact would depend on a number of factors.

**IRS Publication of Curves and Rates.** The IRS will continue monthly publication of the pre-PPA corporate composite bond rates and 30-year Treasury bond rates used to determine transitional segment rates. Additionally, the IRS will provide new monthly corporate bond yield curves, 24-month average funding segment rates, funding transitional segment rates, and minimum lump sum transitional segment rates. The IRS is also expected to issue guidance regarding the new mortality table for calculating lump sum distributions and other forms of payment subject to IRC § 417(e)(3) for 2008 plan years.

IRS Notice 2007-82 can be found at: http://www.irs.gov/pub/irs-drop/n-07-82.pdf