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Pensions and the Current State of the Economy

Wisconsin Association of Government Accountants

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Learning Objectives

At the end of this session, you will be able to:

- Recognize different types of pensions and their benefits and their drawbacks
- Identify how pensions are affected by the economy
- Identify the impact of pensions on the local economy and communities

Recognize different types of pensions and their benefits and their drawbacks

What is a pension?

A pension is a retirement arrangement in which employees receive a regular payment from their employer after retirement in exchange for their years of work.

Pension Plans 101

Defined Benefit Plan (DB) – accumulated contributions and investment earnings are used to pay the member a monthly pension for the life after retirements

"Defined" portion of the DB plan is the benefit that is guaranteed when participants retire

Defined Contribution Plan (DC) – member and the member's employer contribute to an individual account that can be accessed after the member retires

"Defined" portion of a DC account is the contributed amount, not the amount that will be paid out in retirement

Hybrid Plan – includes elements of both a DB and DC Plan

Source: NASRA

Pension Plan Design

Plan design refers to the framework of a retirement plan, defined by such characteristics as participation requirements (mandatory or optional); required contributions by the employer and employees; vesting requirements; benefit levels; methods of benefit distribution; and others.

A 2008 study by the National Institute on Retirement Security, updated in 2014, found that defined benefit plans are 48% more cost efficient than defined contribution plans when measured at any level of retirement benefit.

Plan Design Changes

- Nearly every state has made changes in recent years to their retirement plans.
- DB plans remain the most common for government retirement plans, but hybrid plans are gaining popularity
- There is a lot of variety of retirement plan design out there

No single design will address the cost and risk factors of every state or local government

Advantages and Disadvantages for DB Plans

Advantages

Provides guaranteed lifetime income to retirees

Motivates employees to continue in service

Outside service credit may be recognized

Cost-of-living protection after retirement may be provided

Investment management fees typically lower than DC plan

Disadvantages

Not designed with portability in mind

Difficult for employees to understand how much the employer is contributing on their behalf

Advantages and Disadvantages for DC Plans

Advantages

Contribution amount is easily determined and usually constant from year to year

Account balances may be transferred to next retirement plan at termination

Opportunity for higher benefits if financial experience is superior

Disadvantages

Financial risk of outliving accumulated assets

Financial risk of poor investment return

Retirees are more likely to take a lump-sum benefit than a periodic payment for life

Source: National Institute on Retirement Security

DC vs DB Investment Cost

Average cost of DB plan as a % of payroll: 16.3%

Average cost of DC plan as a % of payroll: 23.0%

Increase related to less balanced portfolio and no longevity risk pooling

Average cost of individually directed DC plan as a % of payroll: 31.3%

Even higher increase related to lower returns/higher fees without same economies of scale

Key Economic Factors

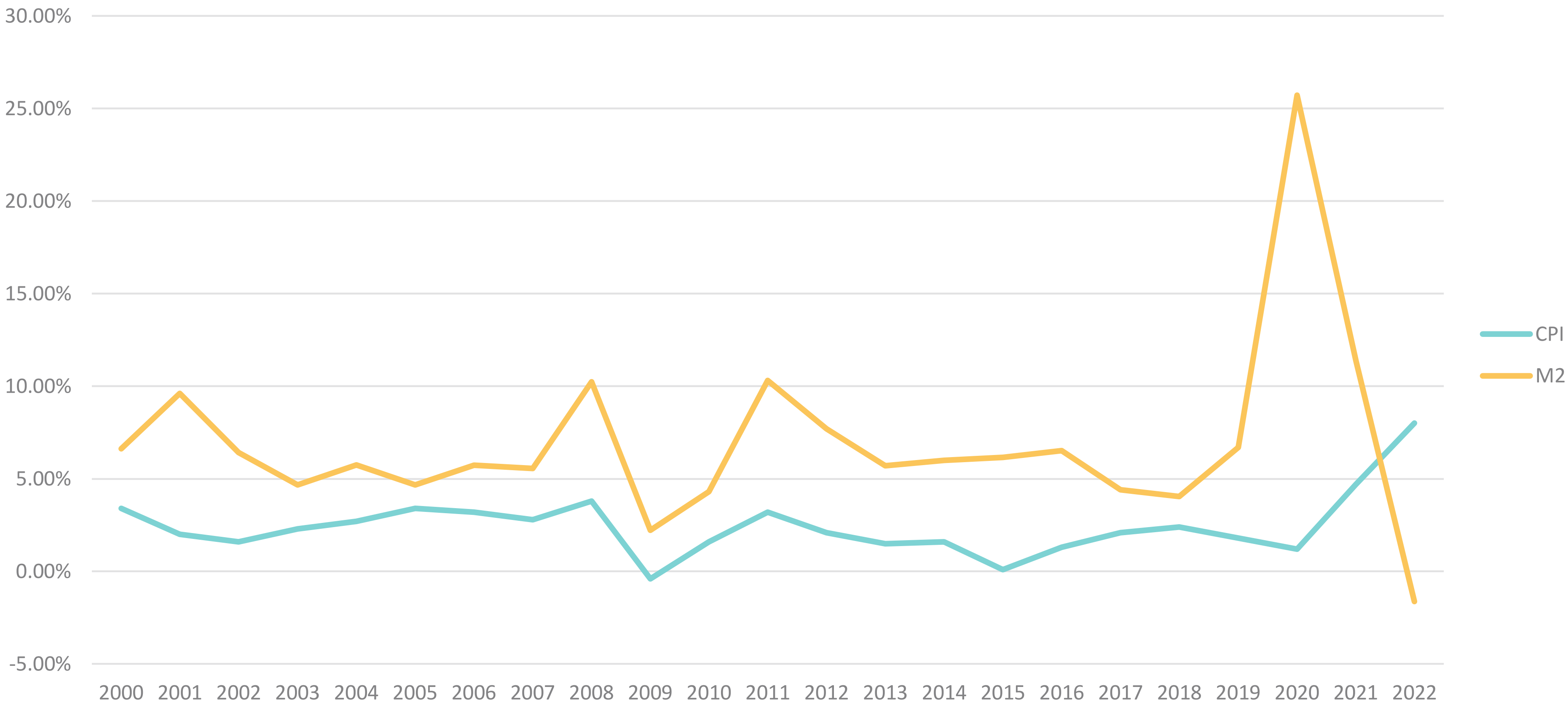
2023 Economic Outlook Predictions

- Looming mild recession in U.S. and Euro area
  - China notable exception with reopening of its economy
- Persistently restrictive monetary policy
- May increase focus on investment in bonds over stocks
- Investors to remain cautious on risk assets

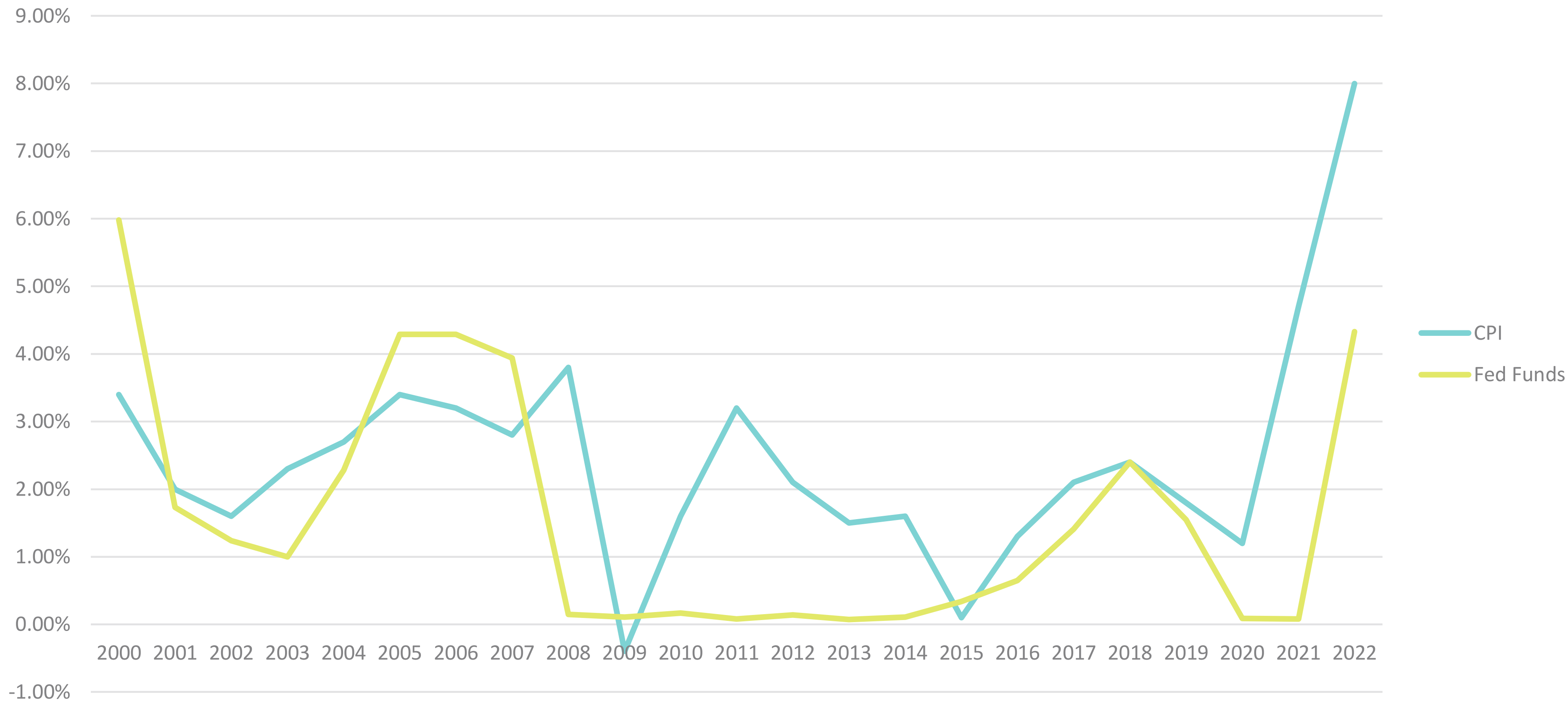
Inflation

Source: Bureau of Labor and Statistics

M2 Money Supply vs. CPI

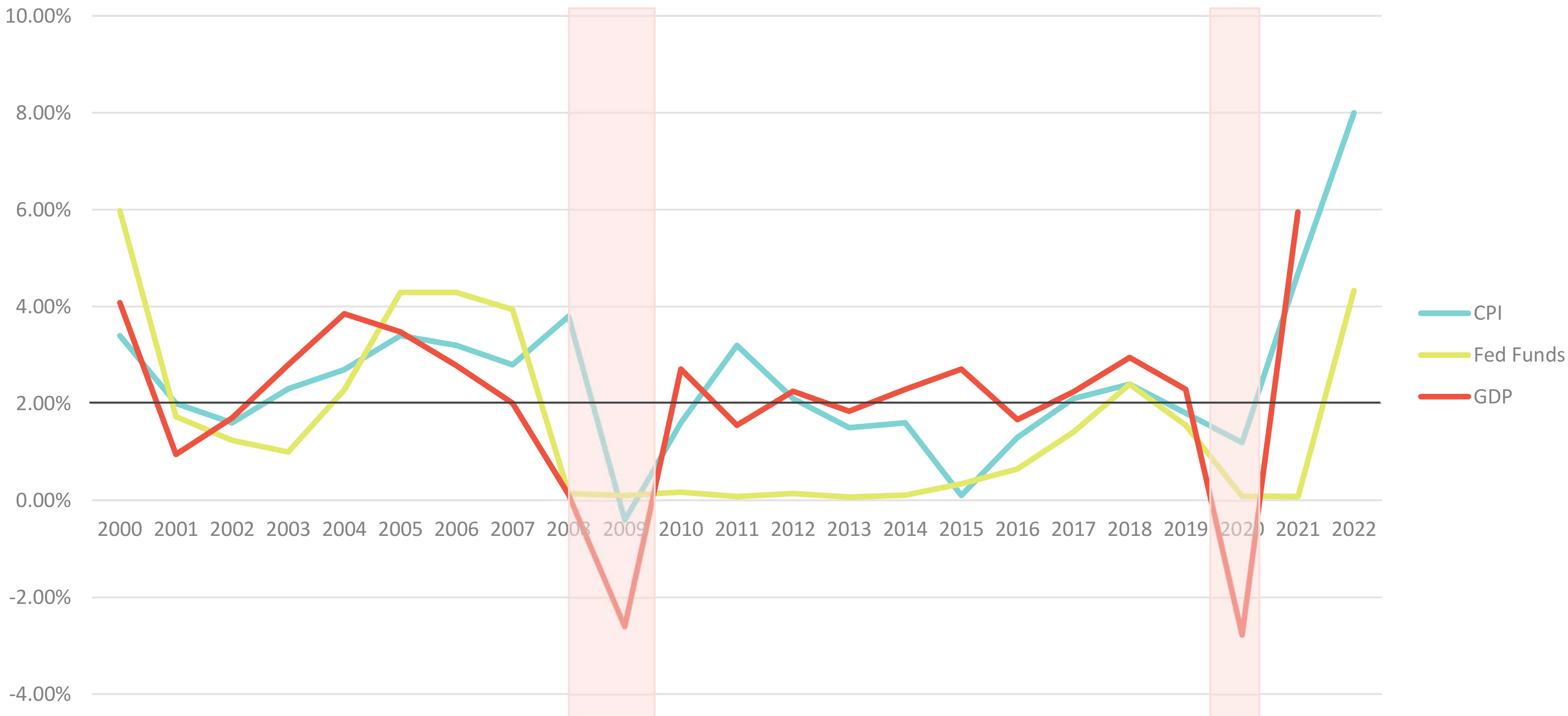


Inflation vs. Fed Funds



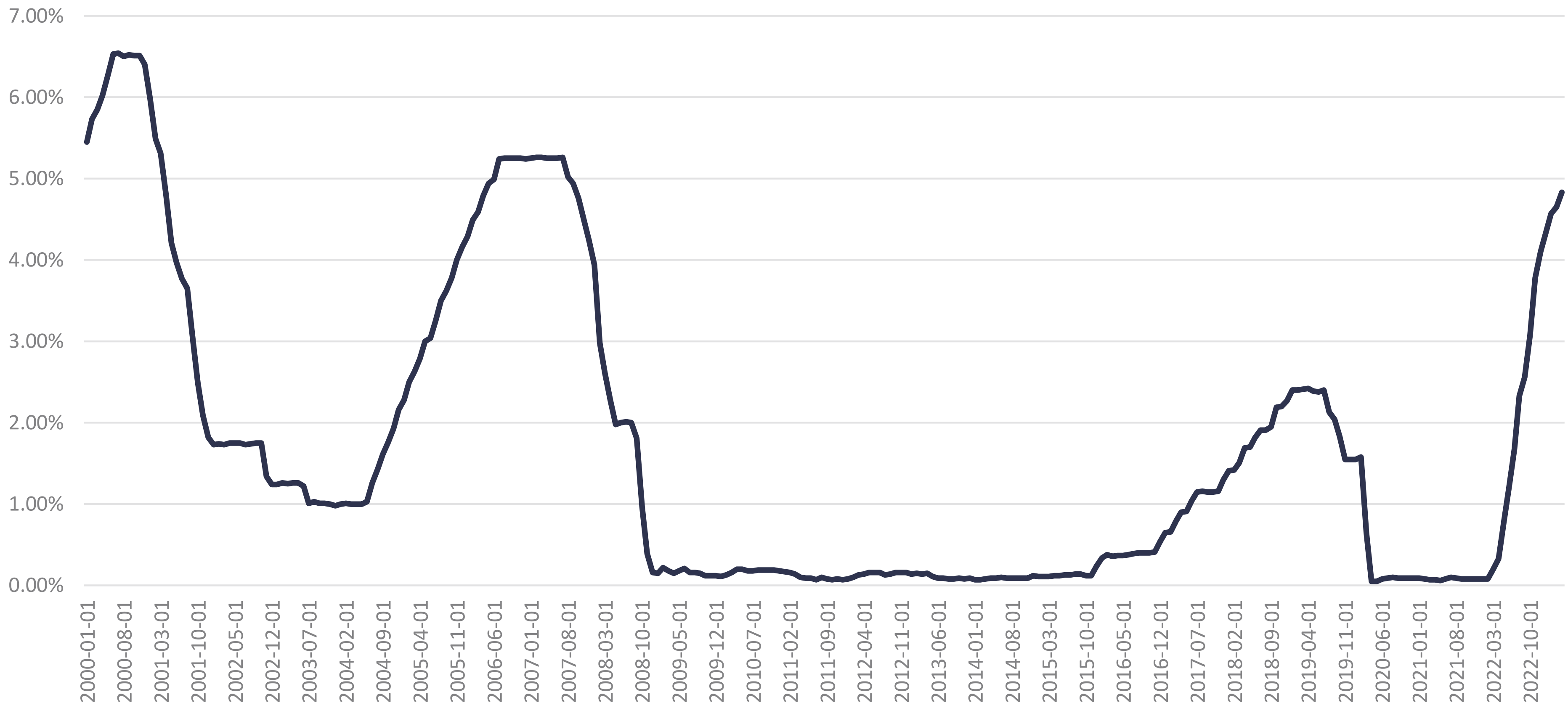
Source: Bureau of Labor and Statistics

Inflation vs. Fed Funds vs. GDP



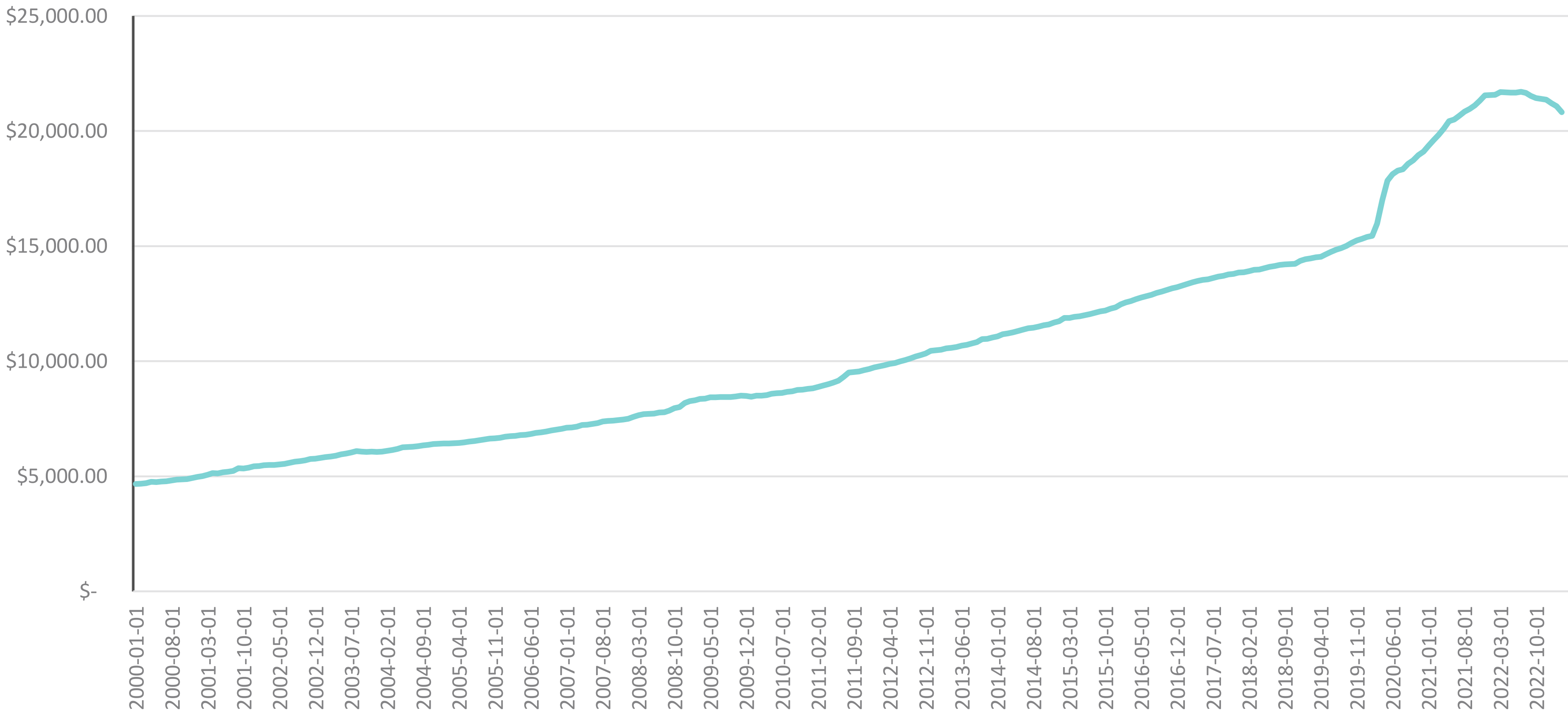
Source: Bureau of Labor and Statistics

Fed Funds Rate



Source: Bureau of Labor and Statistics

M2 Money Supply (in Billions of Dollars)



Identify how pensions are affected by the economy

Key Economy Impacts

Pressure to keep contribution rates down from employers and state lawmakers in times of financial pressure

Large increase in baby boomer retirements adding strain to pension operations and payments

High inflation rates creating pressure to approve COLA's for retirees

2008 recession sparked a shift toward pension reform

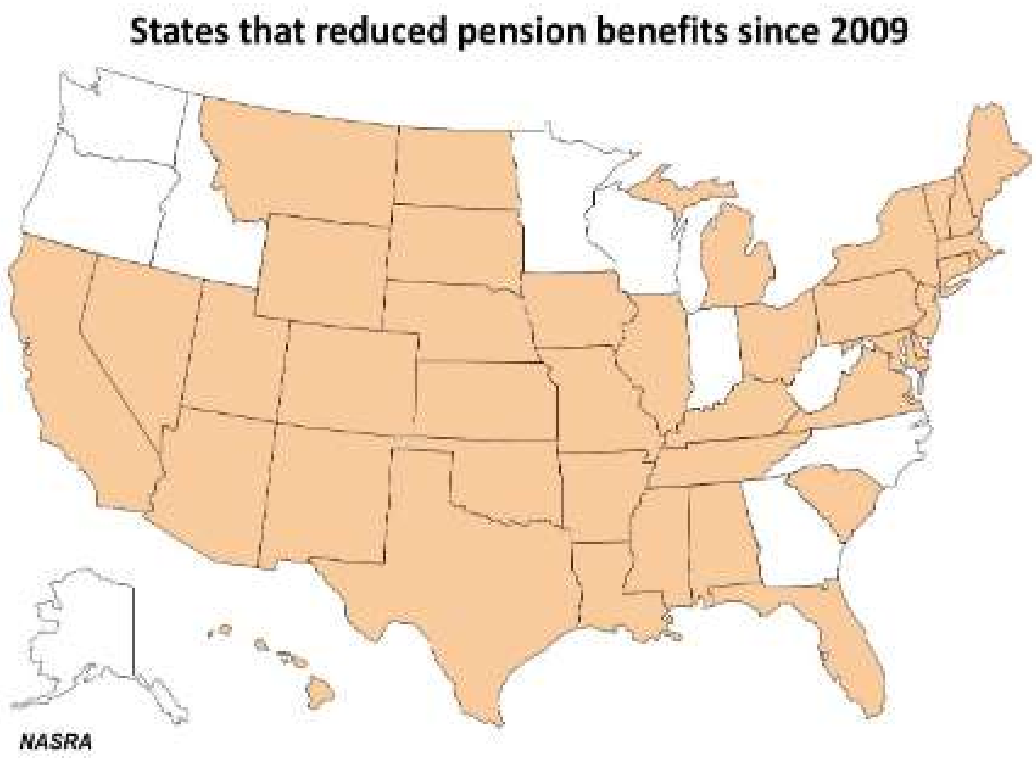
Pension Reform

Source: NASRA

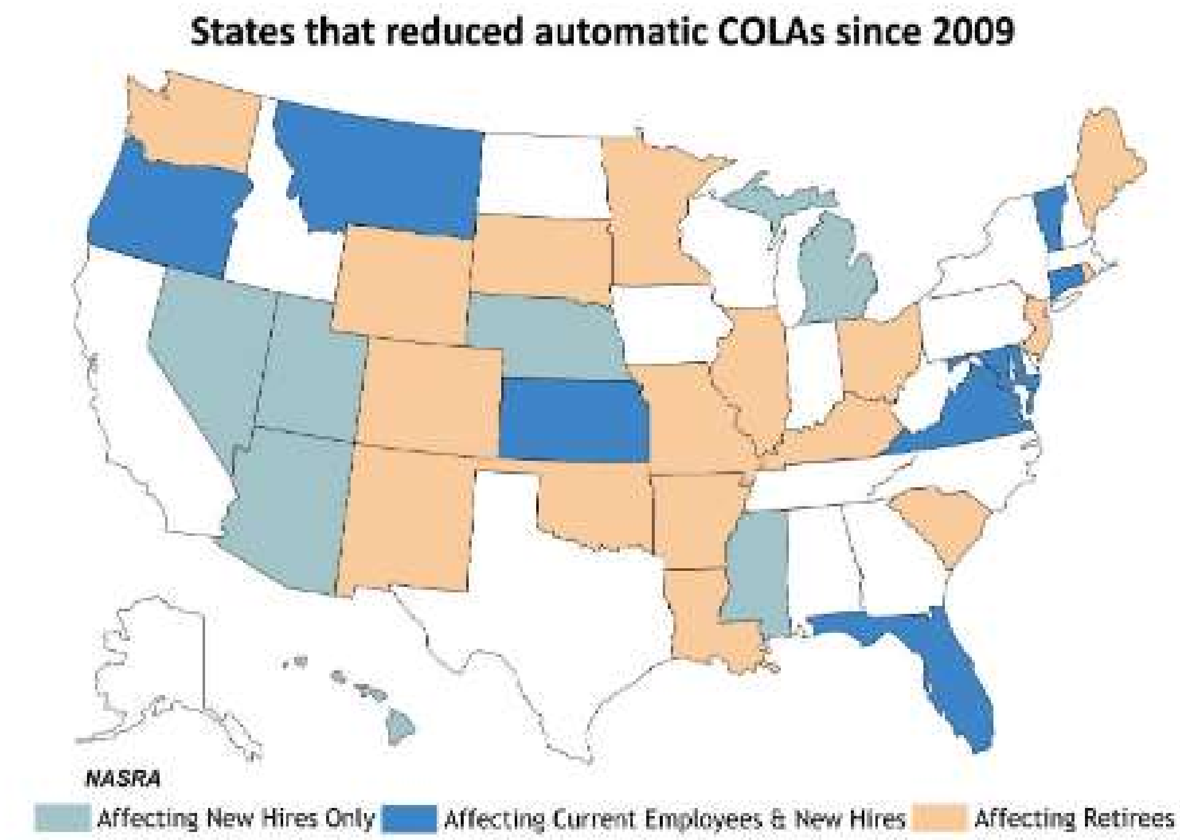
- To accommodate changing needs and fiscal landscapes, modifications to retirement plan designs and financing structures are necessary

Source: NASRA

Pension Reform (continued)

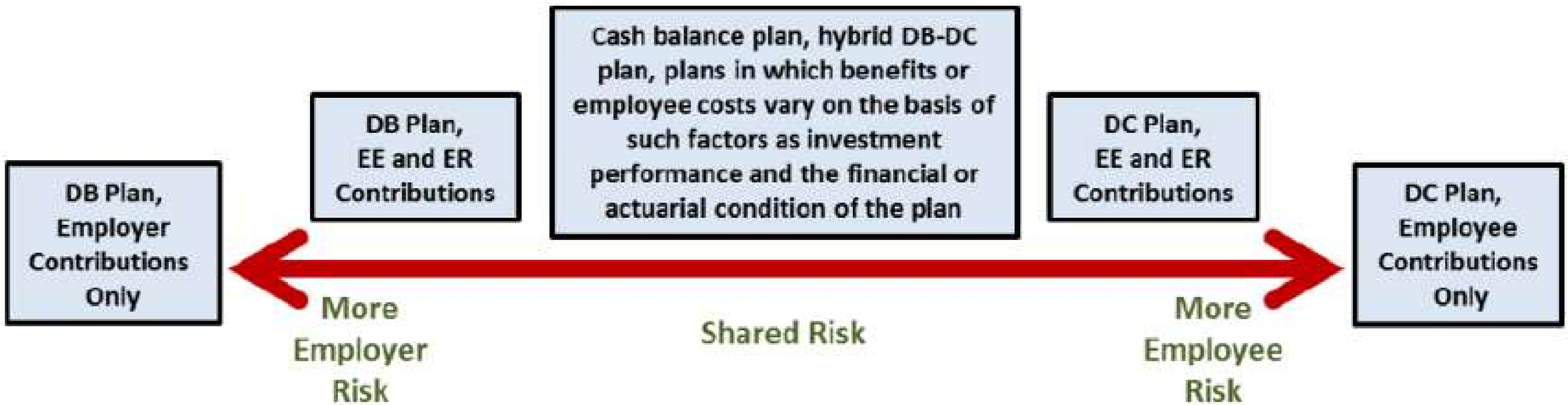


Pension Reform (continued)



Source: NASRA

Who Bears the Risk in Pension Plans?



Source: Brainard, Keith, and Alex Brown. "NASRA Issue Brief: Shared-Risk in Public Retirement Plans," June 2014. (EE refers to employee and ER refers to employer.)

Hybrid Plans

Hybrid plans are a form of risk-sharing plan design that allocate risk between employers and employees. Public retirement plan risk exhibits primarily in three forms: investment risk, longevity risk, and inflation risk.

The term hybrid generally refers to plans that combine elements of both defined benefit and defined contribution plans to generate participants' benefit upon retirement.

Common hybrid plan designs

- Cash balance plans
- Defined benefit-defined contribution (DB-DC) combination plans

Cash Balance Plans

- Elements of traditional pensions and individual accounts
- Usually, employees on a “notional” account where both member and employer contributions are deposited
  - Accounts are pooled for investment purposes
- Accounts accrue an interest rate specified by the plan (not lower than zero, and typically between four and seven percent)
- Future cash balance is somewhat uncertain, as it depends partly on future investment performance.

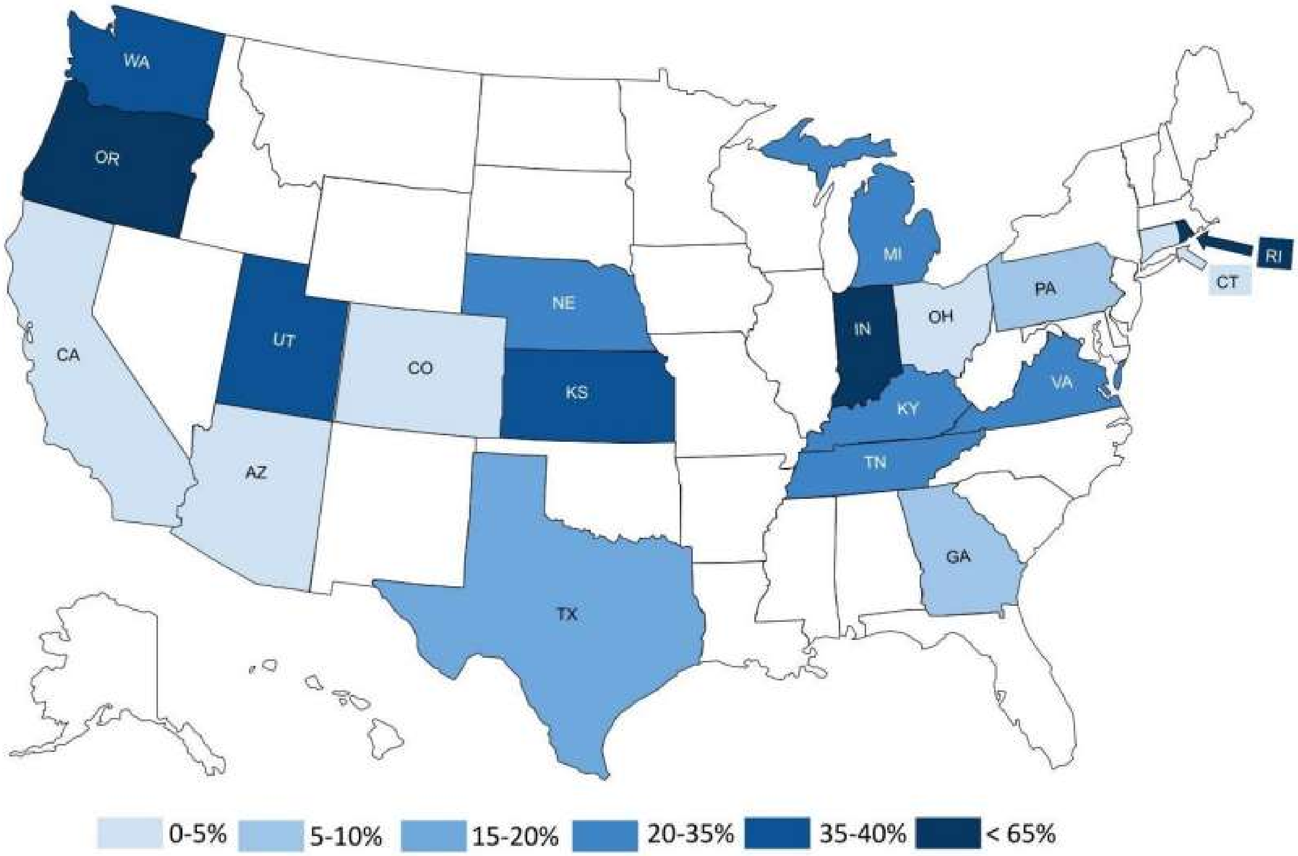
Cash Balance Plans (continued)

- After retirement, depending on the plan design, any portion of the member's notional cash balance account can be converted into an annuity, which is a fixed monthly benefit guaranteed for life.
- The annuity value is dependent on the size of the cash balance account and the discount rate used
- Retirees in payment status may be eligible for benefit increases (COLA's) based on plan's investment performance.

DB-DC Combination Plans

- Two accounts:
  - One traditional DB plan account typically funded by employer contributions
  - One individual defined contribution retirement savings account typically funded by member contributions:
    - Usually mandatory or default participation
    - Typically, more strict rules around member contribution rate changes than what we see for 401(k)'s
    - At retirement, this member contribution account could be used to purchase a higher annuity or is more flexible on withdrawal at retirement than a traditional DB account

Percentage of public employees who participate in a hybrid plan



Source: NASRA Issue Brief: State Hybrid Retirement Plans June 2022

Identify the impact of pension on the local economy and communities

Impacts of Pensions on Participating Employee Workforce

- Mandatory participation
- Limits on using retirement savings for loans
- Competitive benefits = better worker retention
- Reduced turnover with incentives for long term employment

Mandatory Participation

In the private sector, just over one-half of the nation's workforce participates in an employer-sponsored retirement plan

By contrast, for nearly all employees of state and local government, retirement plan participation is mandatory

Forced savings is something state plans have retained

Secure 2.0

- New legislation was recently signed into law targeting private retirement savings to address the problems specific to those without pension plans:
  - Median balance in a 401(k) for Americans ages 65 and up is $87,700, according to data compiled by Vanguard
  - A third of Americans do not have access to any private retirement savings plan, like a 401(k) according to PricewaterhouseCooper

Secure 2.0 (continued)

Some of the provisions of Secure 2.0:

- Require employers to automatically enroll employees starting in 2025. Automatic employee contributions would increase by 1% each year until they reached at least 10%, but not more than 15%.
- Required minimum distribution age raising to 73 this year and 75 in 2033.
- Increased eligibility for part-time workers to participate.
- Increased benefit options related to automatic enrollment for a $2,500 emergency savings account.

Impacts of Pensions on Retired State Employee Workforce

Stable income for elderly population

90% of workers retire to their home state on average

Stable inflows back to the local economy

Assists with keeping elderly above the poverty line

Allows for family planning to support descendants depending on plan options selected

Economic Effects of Pensions

- Recent studies reveal that public pension benefits have positive effects on state and local economies. In 2019, SLG retirement systems in the U.S. distributed $155 billion more in benefits than they received in taxpayer-funded contributions. Personal income from SLG pensions exceeds the personal income derived from the nation's farming, fishing, logging, and hotel/lodging industries combined.

  Source: NASRA

Pension Plan Revenues and Expenses

Funding sources:

Contributions

- Employee
- Employer

Investment earnings

Pension costs:

Benefit Payments

Investment management fees

Administrative expenses

Risk Assessment

- Public pension plans manage a variety of risks, including those relating to investments, operational issues, and the funding or financing of pension benefits
  - Stress testing is an analysis or simulation designed to measure the effect on the plan of various projected investment and actuarial events
  - Sensitivity testing examines the effect on the plan of different actuarial assumptions and methods

Source: NASRA

Actuarial Assumptions

- Actuarial assumptions are projections of future events that affect the cost and funding condition of a pension plan
    - Demographic assumptions – i.e. rate of retirement and mortality, frequency of turnover, rates of marriage and divorce, and age
    - Economic assumptions – i.e. inflation, wage growth, and the investment return on the plan's assets

Source: NASRA

Source: NASRA

System Actuarial Policies and Practices

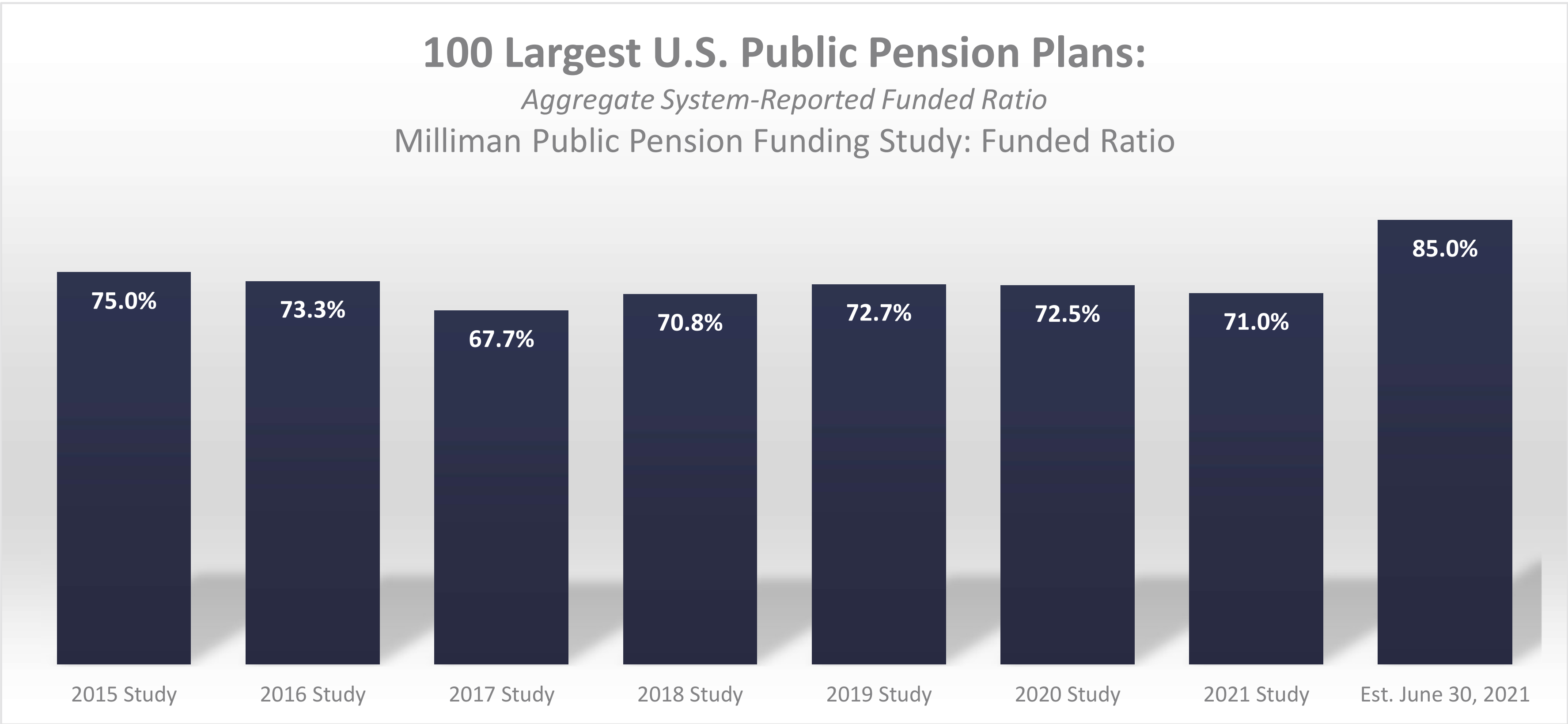
Actuarial Valuation – estimate of a plan's financial position at a specific point in time

Most systems must conduct an actuarial valuation on an annual basis

Experience Study – looks back at the actual experience of the plan compared to demographic and economic assumptions and looks forward using demographic, economic, and capital market projections

Most systems conduct an experience study every five-years

Unfunded Liability



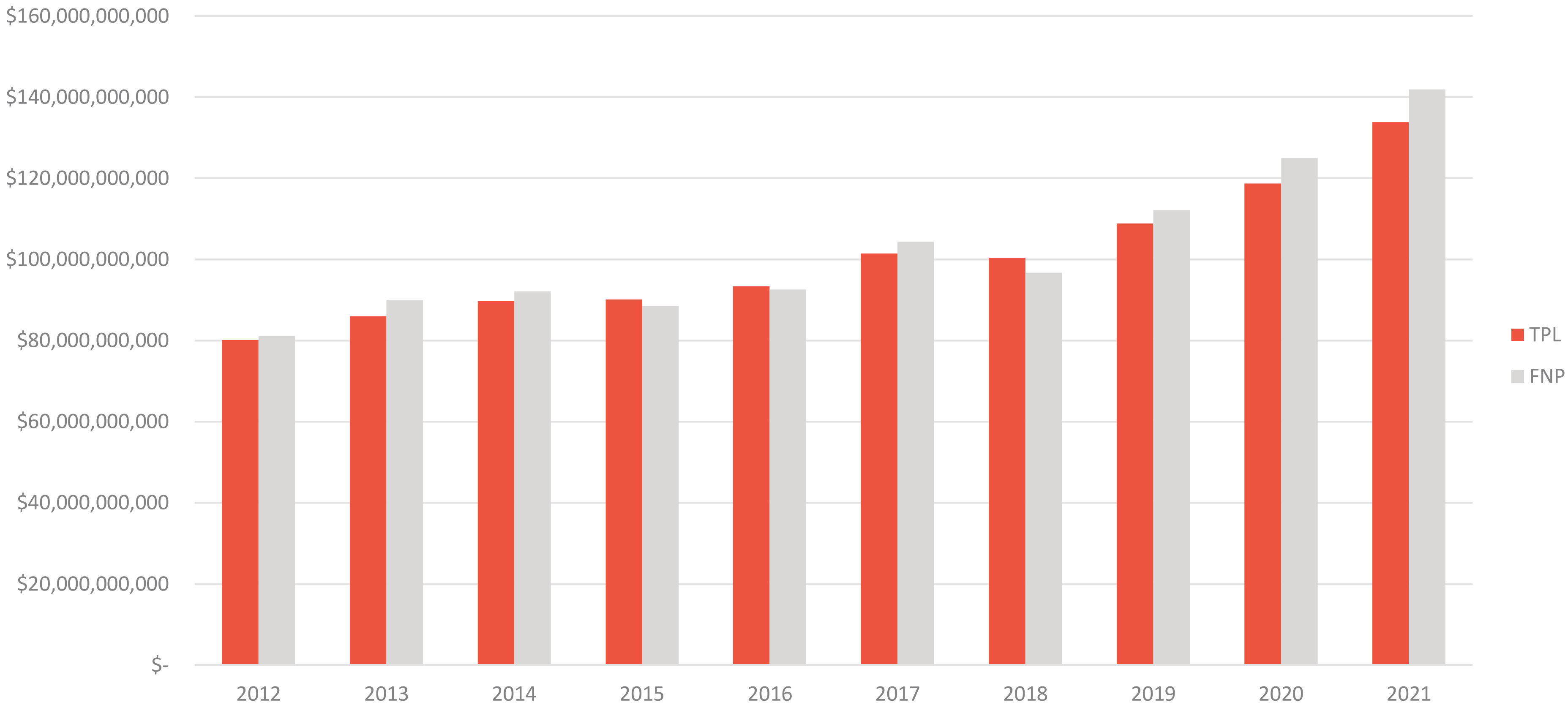
Source: Milliman Public Pension Funding Study   *2021 study covers fiscal-year ending June 2020.
June 30, 2021 estimate covers a portion of pension plans for which year-end reports were available at the time of the analysis.

Wisconsin Retirement System

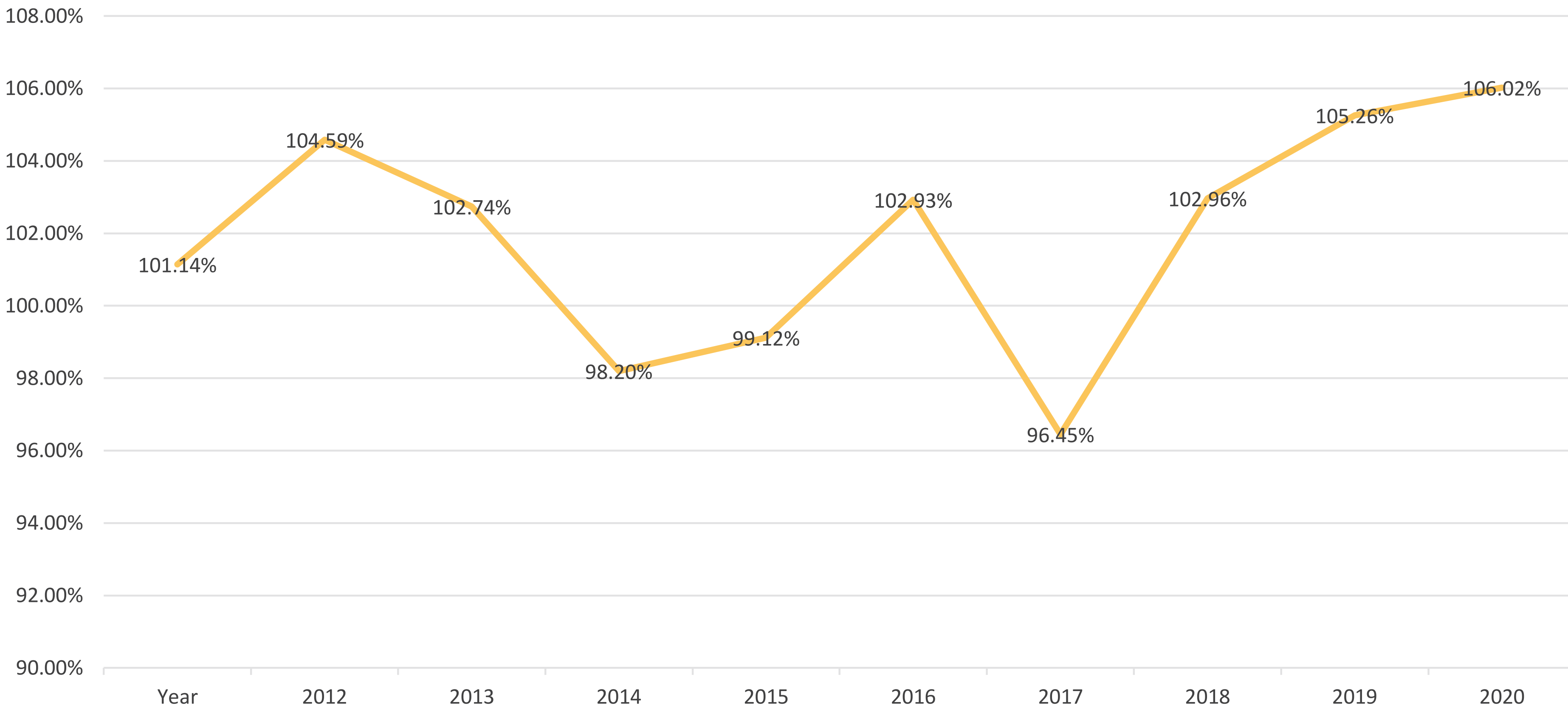
Wisconsin Retirement System – Significant Methods and Assumptions

	2021	2020	2019	2018	2017	2016	2015	2014	2013
Valuation Date:	December 31, 2019	December 31, 2018	December 31, 2017	December 31, 2016	December 31, 2015	December 31, 2014	December 31, 2013	December 31, 2012	December 31, 2011
Actuarial Cost Method:	Frozen Entry Age	Frozen Entry Age	Frozen Entry Age	Frozen Entry Age	Frozen Entry Age	Frozen Entry Age	Frozen Entry Age	Frozen Entry Age	Frozen Entry Age
Amortization Method:	Level Percent of Payroll-Closed Amortization Period	Level Percent of Payroll-Closed Amortization Period	Level Percent of Payroll-Closed Amortization Period	Level Percent of Payroll-Closed Amortization Period	Level Percent of Payroll-Closed Amortization Period	Level Percent of Payroll-Closed Amortization Period	Level Percent of Payroll-Closed Amortization Period	Level Percent of Payroll-Closed Amortization Period	Level Percent of Payroll-Closed Amortization Period
Amortization Period:	30 Year closed from date of participation in WRS	30 Year closed from date of participation in WRS	30 Year closed from date of participation in WRS	30 Year closed from date of participation in WRS	30 Year closed from date of participation in WRS	30 Year closed from date of participation in WRS	30 Year closed from date of participation in WRS	30 Year closed from date of participation in WRS	30 Year closed from date of participation in WRS
Asset Valuation Method:	Five Year Smoothed Market (Closed)	Five Year Smoothed Market (Closed)	Five Year Smoothed Market (Closed)	Five Year Smoothed Market (Closed)	Five Year Smoothed Market (Closed)	Five Year Smoothed Market (Closed)	Five Year Smoothed Market (Closed)	Five Year Smoothed Market (Closed)	Five Year Smoothed Market (Closed)
Actuarial Assumptions									
Net Investment Rate of Return:	5.4%	5.4%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%
Weighted based on assumed rate for:									
Pre-retirement:	7.0%	7.0%	7.2%	7.2%	7.2%	7.2%	7.2%	7.2%	7.2%
Post-retirement:	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Salary Increases									
Wage Inflation:	3.0%	3.0%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%	3.2%
Seniority/Merit:	0.1%-5.6%	0.1%-5.6%	0.1%-5.6%	0.1%-5.6%	0.1%-5.6%	0.1%-5.6%	0.1%-5.6%	0.1%-5.6%	0.1%-5.6%
Post-retirement Benefit Adjustments*:	1.9%	1.9%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%	2.1%

Wisconsin Retirement System – Total Pension Liability vs Fiduciary Net Position

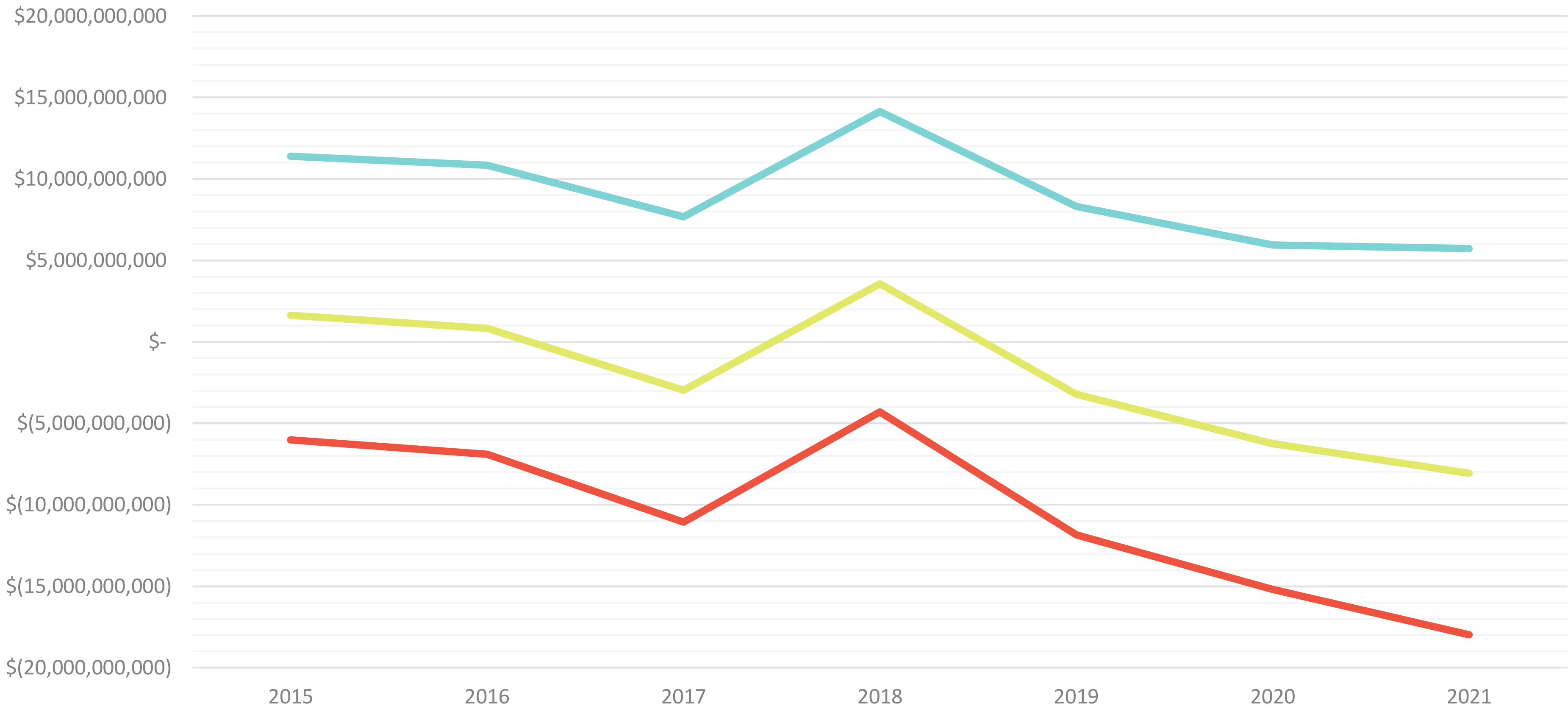


Wisconsin Retirement System - Net Pension Asset (Liability)

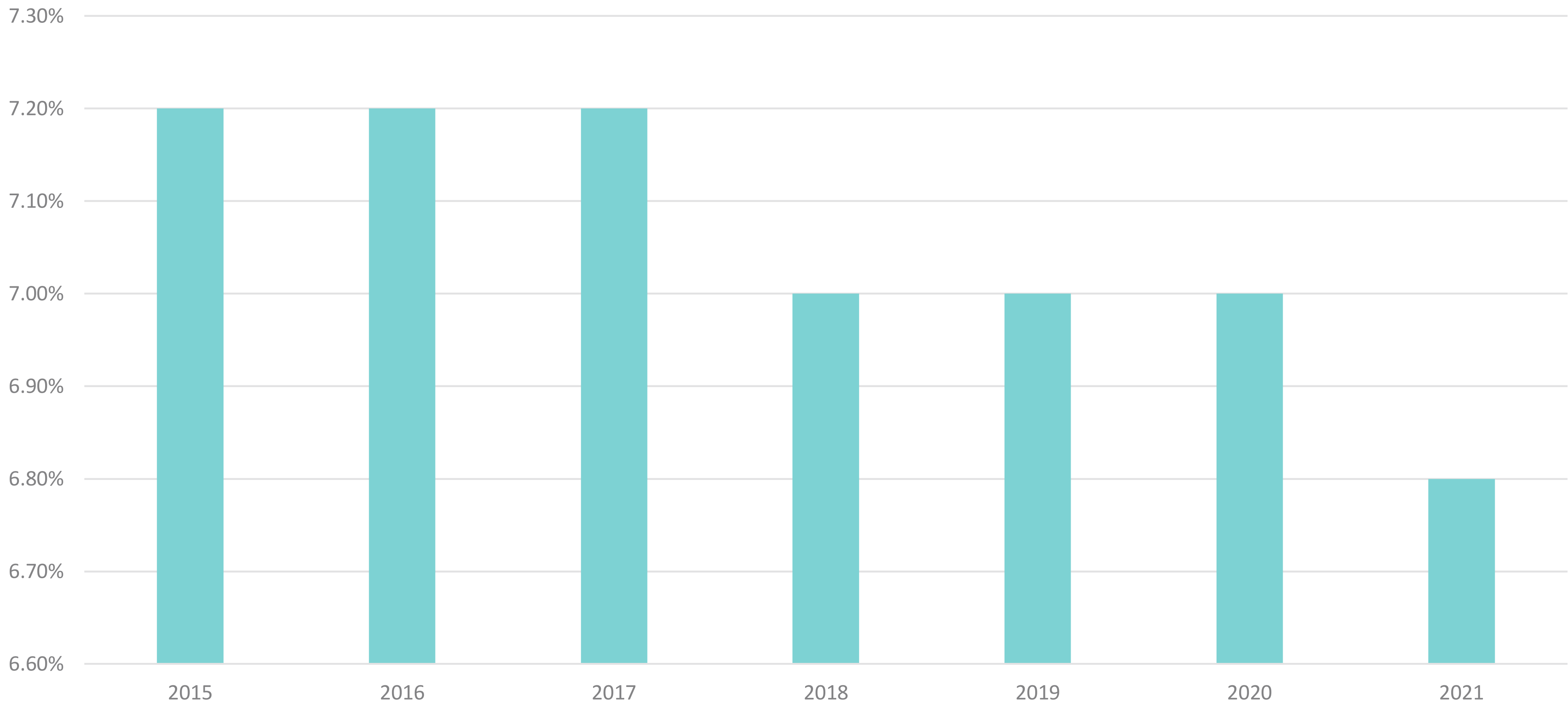


Source: Wisconsin Retirement System

Wisconsin Retirement System – Sensitivity Analysis



Wisconsin Retirement System – Discount Rate

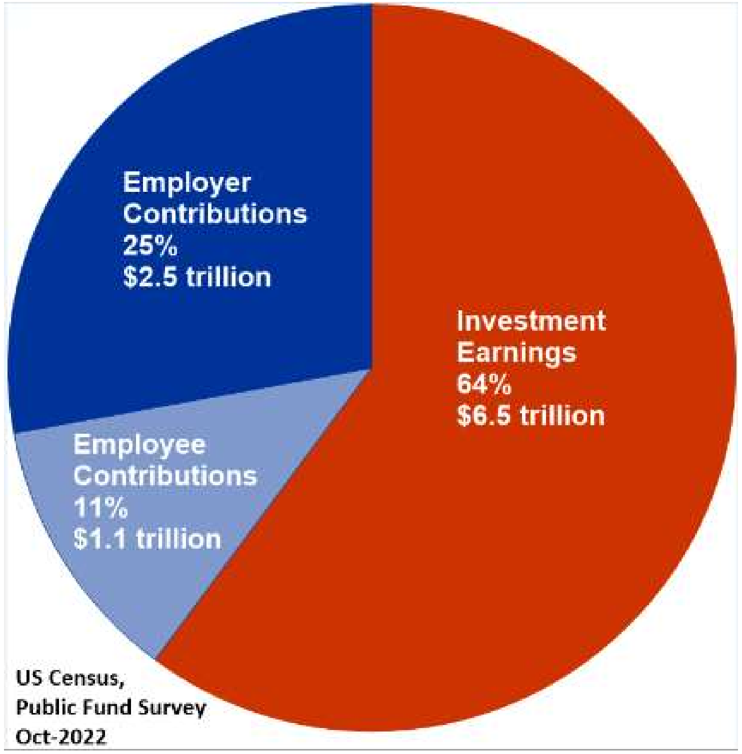


Employer Contributions

In FY19, 5.01% of all state and local government spending is used to fund pension benefits for employees of SLG. Source: NASRA

Actuarially Determined Employer Contribution (ADEC) – amount needed to finance benefits accrued each year, plus the annual cost to amortize unfunded liabilities from past years, less required employee contributions

Public Pension Sources of Revenue, 1992-2021

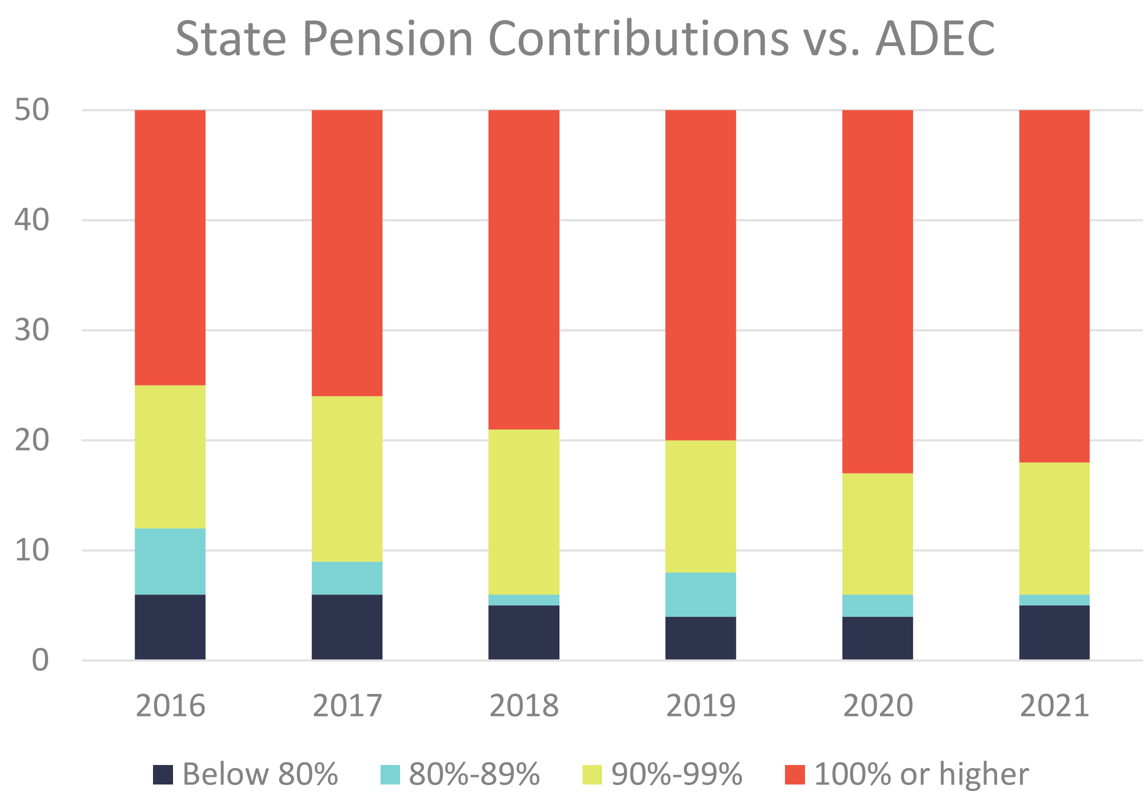


Source: NASRA

Wisconsin Retirement System – General Employee Contribution Rates

ADEC

- In FY21, 32 states made at least its actuarially determined pension contribution compared to FY16 where 25 states met at least 100% of the ADEC
- Trend toward more states making payments equal to or greater than the ADEC to improve funded status

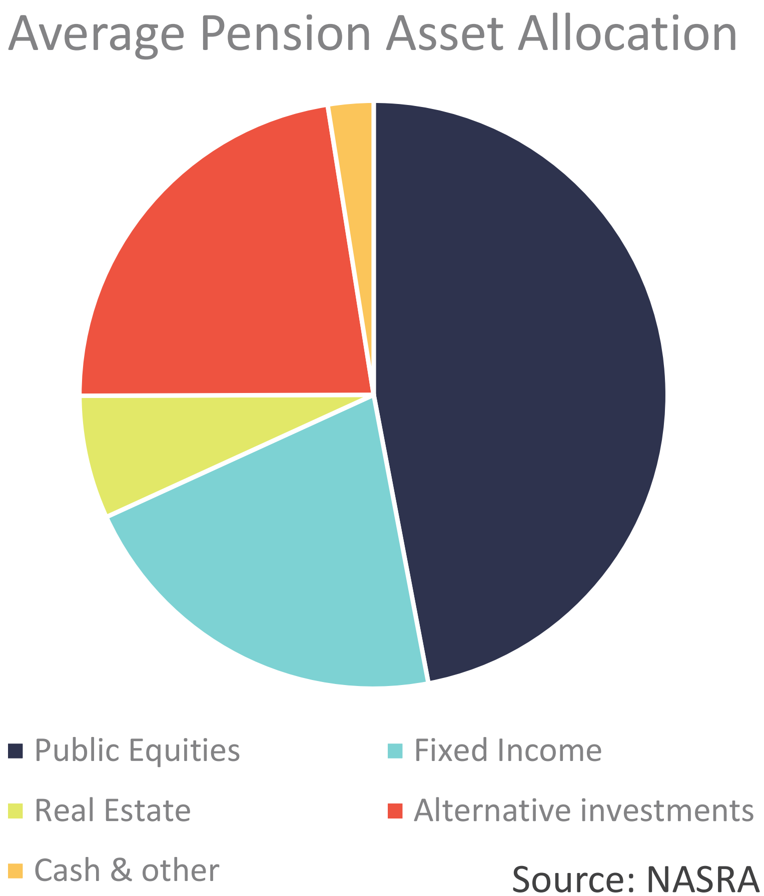


Source: Larry Rothman, 11-10-22, Pensions & Investments

Investments – Diversified Portfolios

- Public pension asset allocations typically are developed as part of a process that considers the plan's liability stream, or projected benefit payments, expected revenue from contributions, and investment earnings

Investment Policy is the most important element in the investment structure!



Source: NASRA

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