



March 15, 2006

Mr. Michael H. Moskow
President and CEO
Federal Reserve Board of Chicago
230 S. LaSalle Street
Chicago, IL 60604-1413

Dear Mr. Moskow:

We are writing because we share your concern about the future of public retirement plans. Together, the authors of this letter have over 35 years of experience conducting surveys and other research related to state and local government retirement plan administration, benefit design, investments, actuarial valuations, and plan funding. Paul Zorn is Director of Governmental Research for Gabriel, Roeder, Smith & Company, a consulting firm that specializes in state and local benefit plans and provides actuarial and other services to over 400 public sector clients. Keith Brainard is Director of Research for the National Association of State Retirement Administrators (NASRA), a non-profit organization for directors and administrators of statewide retirement systems currently covering 16 million working and retired employees.

We read with interest your remarks to the State and Local Government Pension Forum on February 28. We recognize your concerns about public pension funding and the potentially large liabilities related to retiree health care benefits. We also share your concerns about the future of retirement benefits for millions of public employees, including teachers, police officers, firefighters, judges, and other public officials. However, we respectfully disagree with several of your conclusions. Our comments below are intended constructively, in support of sound public policy relating to an important issue with far-reaching ramifications affecting millions of working and retired Americans.

Growth of Public Pension Unfunded Liabilities

The speech characterizes the funding of state and local retirement plans as a problem that will grow rapidly and ultimately reduce the ability of governments to fund other public programs. With regard to public pension plans, we believe this characterization does not accurately reflect the current financial status of plans that cover the vast majority of public employees, nor does it accurately reflect the reasons for the recent decline in the plans' funding condition.

For the most part, state and local retirement plans in the U.S. are in good financial shape. According to the Public Fund Survey, the average funded ratio of large public

retirement plans in the U.S. was 88 percent in 2004, with 7 out of 10 plans at least 80 percent funded.¹ While a handful of large plans do have funded ratios below 60 percent, the overall financial health of the retirement plans covering the vast majority of public employees is good. To characterize the current state of public pension plans as “a mess” is to misstate the problem.

The dramatic decline in domestic equity markets that occurred from 2000 through 2002 is the single largest factor influencing the recent growth in unfunded liabilities for public pension plans. Prior to 2000, the vast majority of public plans were well funded and there was no talk of a pension crisis. Then, from 2000 through 2002, domestic stocks lost about 40 percent of their value, the largest market decline since the Great Depression. As a result, public plan funded ratios fell, on average, from a little over 100 percent to about 88 percent now. Even at this level, because of the way the calculations are made, accrued benefits based upon salary and service to date are most likely to be fully funded. Moreover, public plans weren't the only ones affected: the declines in asset values created problems for all retirement plans alike – public and private, defined benefit and defined contribution.

Growth in Employer Contributions

Increased unfunded actuarial liabilities are usually amortized through increases in employer contribution rates. Consequently, the declines in the equity markets caused employer contribution rates to rise. To dampen the immediate impact of large, short-term market fluctuations on employer contributions, most public plans use asset smoothing techniques to gradually recognize investment gains and losses over three to five years. Consequently, even after the investment markets improved in 2003, employer contributions continued to increase.

The good news is that the investment gains from 2003 through 2005 are also being smoothed into the value of assets, and will likely cause employer contributions to stabilize. This is echoed in the recent Standard & Poor's report which observes, if “funds produce adequate investment returns in fiscal 2006, then we may see funded ratios begin to stabilize.”²

Moreover, when viewed in the context of total state and local government spending, governments (and thus taxpayers) spent less on public pension plans in 2004 than they did during the mid-1990s. From 1995 through 1997, state and local government contributions to pension plans were about 3.0 percent of total state and local government spending annually. By 2002, this had fallen to 1.9 percent, due partly to the smoothing in of investment gains earned during the late 1990s. After 2002, government contributions increased and reached 2.2 percent in 2004, still lower than the 3.0 percent paid in the mid-1990s.³

¹ The Public Fund Survey is currently the broadest and most detailed survey of public plans. Sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement, it presents information on the benefits, funding levels, actuarial assumptions, and investments of 127 of the nation's largest public plans, covering approximately 88 percent of all public employees covered by state and local retirement plans.

² Standard & Poor's, “Rising U.S. State Unfunded Pension Liabilities Are Causing Budgetary Stress,” February 22, 2006, p. 5.

³ U.S. Census Bureau, “State and Local Government Retirement Systems,” and “State and Local Government Employment and Payroll.”

Measuring the Unfunded Liability

The speech uses Barclays Global Investors' \$700 billion estimate of public pension plan unfunded liabilities. We believe this figure significantly overstates public pension unfunded liabilities and that the best measure of these liabilities is provided in the actuarial valuations done for the plans. Using this measure, we estimate total current unfunded liabilities for all state and local pension plans to be about \$385 billion, roughly half of the Barclays' estimate.

The Barclays' estimate is based on a present value discount rate reflecting fixed-income securities, whereas most pension portfolios are composed of a diversified mix of equity and fixed-income investments, including public and private equities. The problem is that the present value calculation is intended to reflect the amount needed today that, when invested, would be sufficient to pay future benefits. A discount rate based solely on fixed-income investments would systematically overstate the long-term cost of benefits. Moreover, under the Governmental Accounting Standards Board's rules, the discount rate should reflect the expected long-term rate of return on plan investments for determining the cost of pension benefits reported in governmental financial reports. As discussed in GASB Statement No. 25, the GASB considered but rejected using the long-term bond rate as the discount rate for governmental pension plans.⁴

In addition, for an unfunded liability figure to truly have meaning, it must be measured in the context of available assets. For the fourth quarter of 2005, the Federal Reserve reported that public pension plans held assets of \$2.72 trillion,⁵ a figure that has surely grown in the ensuing period and that far outweighs estimates of unfunded liabilities. Even if policymakers made no changes to public pension plan designs (including to contribution rates), most public pension plans still would have assets sufficient to continue paying their promised benefits, at a minimum, for decades into the future.

Applying ERISA Rules to Public Plans

The speech suggests that a solution to public plan funding would be to make the plans subject to standards similar to those in the Employee Retirement Security Act of 1974 (ERISA), on the grounds that this would make it more difficult for governments to increase pension benefits without identifying adequate funding. While we agree on the importance of funding promised benefits, we disagree that federal legislation like ERISA would be a solution.

First, the current problems with private-sector pension plans demonstrates the weaknesses of ERISA in ensuring plan funding. As the GAO has pointed out, the "current funding rules do not provide adequate mechanisms for maintaining adequate funding of pension plans."⁶

Second, the cost of satisfying ERISA's complicated rules is considered one of the reasons for the decline in private sector pension plans. In 1997, the Employee Benefits

⁴ Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, Governmental Accounting Standards Board, paragraphs 135 – 137.

⁵ Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," Fourth Quarter 2005.

⁶ U.S. General Accounting Office, "Private Pensions: Changing Funding Rules and Enhancing Incentives Can Improve Plan Funding," October 29, 2003, Summary.

Research Institute published a report on the rise of defined contribution plans in the private sector. In its discussion of the impact of ERISA and other legislative changes, the authors observe: “Many argue that new laws and regulations have raised the DB administrative costs enough to make DC plans more attractive to plan sponsors.”⁷

It is true that a handful of large public plans are facing funding difficulties and that in several cases this is a result of employers’ unwillingness to fully fund the plans. However, to remedy this, changes to state laws would be more appropriate than the imposition of a one-size-fits-all set of federal regulations. Indeed, a strong argument can be made that state and local government pension plans have, for the most part, flourished in the absence of federal controls, operating instead under governance structures prescribed by state constitutions, statutes, and case law.

A resolution approved by NASRA in 1996 states, in part, “public employee retirement systems already have in place full disclosure, reporting, accounting, and fiduciary standards set by state and local governments and, further, these systems have significantly improved their funding, disclosure, administration and investment management over the past decade; ... federal regulation that would mandate certain standardized reports, actuarial and accounting analyses, and disclosure ... would needlessly duplicate what is already required of state and local government retirement systems.”⁸

Moving to Defined Contribution Plans

The speech also suggests that moving to defined contribution plans could be a way to reduce government costs while better meeting the needs of workers. While we agree that defined contribution plans can be a useful vehicle to supplement pension benefits by encouraging additional employee retirement savings, we disagree that replacing defined benefit plans with defined contribution plans is a way to reduce government costs or to better meet the needs of workers.

First, as you point out, many state and local governments have strong legal protections on retirement benefits – often based in the state’s constitution. Consequently, a defined benefit plan would still need to be maintained (and funded) for currently covered workers. The new defined contribution plan would be established for newly hired workers at an additional cost to the government. Moreover, because the defined benefit plan would be closed to new hires, stricter accounting standards would apply, effectively increasing the annual required contributions to the defined benefit plan. Any savings that would result from this change would take 10 to 15 years to be realized.⁹

⁷ Employee Benefit Research Institute, “Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega Defined Benefit Plans Remain Strong: Where We Are and Where We Are Going,” 1997, p 30.

⁸ National Association of State Retirement Administrators, Resolution 1996-04, available at: <http://www.nasra.org/resolutions.htm>

⁹ Los Angeles County Employees Retirement Association, “Proposals to Close Public Defined Benefit Plans,” March 16, 2006. The study estimated that the County’s DB plan annual contribution rate would increase by 3.66% (\$206 million) if employees hired after July 1, 2007, were required to join a DC plan. While the contribution rate would gradually decline over time, the County would have to wait until 2018 to see any savings in DB plan costs as a result of the change.

Second, defined contribution plans have not been particularly successful in providing adequate retirement benefits, for a number of reasons, including: (1) most DC plan participants don't contribute enough; (2) they tend to invest conservatively which results in lower long-term rates of return than professionally managed assets; (3) they take money out when they change jobs; and (4) they spend it too quickly in retirement. A recent Congressional Research Service study found that only half of older workers in 401(k) plans had saved enough to provide an annual benefit of at least \$5,000 from their account.¹⁰ By comparison, public retirement plans paid an average annual benefit of about \$19,800 in 2004.¹¹

Third, defined benefit plans can be flexibly designed to meet a broad array of objectives for all stakeholders, including public employers, taxpayers, and public employees. As indicated in a 2003 NASRA resolution expressing support for state and local defined benefit plans, such plans can have "progressive changes ... that accommodate a changing workforce and better provide many of the features advanced by defined contribution advocates."¹² Indeed, many public pension plans have and continue to incorporate flexible features into their benefit structures.

Other Postemployment Benefit (OPEB) Plans

While we believe most public pension plans are well-funded, we recognize this is not the case for most public OPEB plans, including plans for retiree health care. However, we also believe that the issues related to public pension and OPEB benefits should be treated separately. The issues surrounding OPEB funding are substantially different than the issues surrounding pension funding. In most cases, retirees and beneficiaries share in the ongoing costs of retiree health care through deductibles and co-pays. Moreover, in many cases, employers reserve the right to change the retiree health care benefit, and have done so by changing eligibility provisions and by requiring retirees to pay a greater portion of the premiums.

Consequently, retiree health care benefits are not guaranteed in the same way as the pension benefits for many governments. Unfortunately, this will likely mean that more of the health care costs will be shifted to retirees, at a time when they are least able to afford them. However, if health care costs continue increasing at current rates, it won't be long before no one will be able to afford them. Controlling the growth of health care costs is the key to affording these benefits. This is an issue that goes beyond state and local governments.

Broader Economic Implications

The discrepancy in retirement benefits paid through defined benefit and defined contribution plans raises an even broader public policy question: What will happen to the U.S. economy as more people retire? Over the next 25 years, the U.S. population age 65 and older is expected to double, from 37 million in 2005 (12% of total population) to

¹⁰ Patrick J. Purcell, "Retirement Savings and Household Wealth: A Summary of Recent Data," Congressional Research Service, December 11, 2003.

¹¹ U.S. Census Bureau, "State and Local Governments Public Employee Retirement System Survey," 2004. Average calculated by authors.

¹² National Association of State Retirement Administrators, Resolution 2003-08, available at: <http://www.nasra.org/resolutions.htm>

70 million (20% of total population) by 2030.¹³ It is likely that, as a result of the movement to defined contribution plans, the income of many of these retirees will be significantly less than their pre-retirement income. Consequently, demand for goods and services will likely be significantly lower or governmental intervention of some type may be needed. Lower incomes could mean less economic stimulus for the economy, possibly for many years.

By providing sufficient and sustainable retirement income, state and local defined benefit plans help to support the U.S. economy over the long-term. Moreover, they act as financial engines by investing employer and employee contributions to generate investment earnings that provide income to retired public employees over their lifetimes. Since 1982, state and local retirement plans' investment earnings have amounted to over \$2.0 trillion, compared with total employer contributions of about \$825 billion and total member contributions of \$400 billion. During this period, taxpayer dollars paid 25 percent of the cost of public retirement benefits, with the remaining 75 percent coming from investment returns and member contributions.

A 2004 working paper prepared for the Pension Research Council at the Wharton School estimated that the higher investment returns generated by public pension funds, relative to defined contribution returns, creates an economic stimulus of 2.0 percent of GDP, or more than \$200 billion, annually. This stimulus is continuous and steady, as the dollars produced by the higher returns are distributed to retired public employees and their beneficiaries in every city and town across the nation.¹⁴

Steps to Improve Public Plan Sustainability

While we believe most public plans are in good financial condition, we also believe there are steps that plans can take to improve their sustainability, especially in light of a more volatile investment environment. First, to reduce downside investment risk, plans should review their asset allocations in light of likely investment returns and the duration of their liabilities. Second, governments should avoid providing benefit increases based on plan "overfunding" or "excess assets." Third, governments should consistently contribute the amounts necessary to fund their pension plans and, if feasible, should establish reserves to help ensure contributions are made during cyclical economic declines.¹⁵ Finally, to the extent benefits cannot be sustained, new benefit tiers should be established to provide more sustainable pension benefits to new hires.

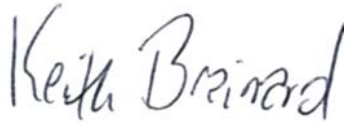
¹³ Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 2005 Annual Report, p. 77.

¹⁴ Gary Anderson and Keith Brainard, "Profitable Prudence: The Case for Public Employer Defined Benefit Plans," PRC Working Paper 2004-6, Pension Research Council, The Wharton School, 2004.

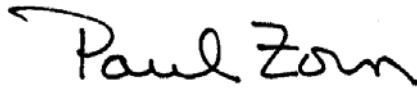
¹⁵ For a concise summary of steps that state and local governments can take to help ensure their plans are properly funded, see the Government Finance Officers Association's recommended practice: "Funding of Public Employee Retirement Systems" at: <http://www.gfoa.org/documents/persfundinggrp.pdf>

Mr. Moskow, as President of the Federal Reserve Board of Chicago, you are in a unique position to support sound public policy with regard to retirement benefits. We hope the information offered in this letter will be useful to you. Please let us know if you have any questions or would like additional information.

Respectfully,



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