Solving the Public Pension Plan Funding Crisis

John T. Hausladen
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The current menu of solutions to fix public pension plans and reduce funding deficits has been partially adopted by plan sponsors and legislative bodies across the nation. But today’s approaches still leave plan sponsors without a long-term solution to chronic underfunding.

Today’s proposals include raising contribution rates on the part of employees, extending retirement ages, capping retirement payments and establishing defined contribution plans for new employees. All are touted with great fanfare as solutions. Yet these proposals will not provide any significant reduction in funding deficits because of the continued assumption of investment and longevity risk by public plan sponsors. I propose a combination of liability-driven investing and a risk-transfer mechanism to gradually eliminate plan liabilities.

Why current proposals will fail

There are two primary reasons why current proposals are ineffective: they ignore escalating retiree liability and its associated risks, and asset allocation is mismatched to liabilities.

Public defined-benefit plans mature with, on average, more than 50% of actual liability attributable to current retirees. In the 100 largest public pension plans, retiree liabilities account for $1.98 trillion of $3.6 trillion total liabilities.¹ Increasing employee contributions, extending retirement ages and establishing defined contribution plans will have no effect on existing retiree liabilities. Secondly, public pension plans are burdened with statutory return assumptions ranging from 7.5% to 8.5%. The higher return assumptions skew asset allocation towards higher volatility or illiquid investments including private equity, hedge funds and other alternative asset classes. As a result, during periods of equity market declines, investments have to be liquidated at losses to fund the current and fixed liabilities of the plan.

Pension plan liability risk has been transferred and reduced for decades through various strategies, including terminal funding, liability-driven investing and risk transfer to other

¹ 2012 Public Pension Funding Study, Milliman

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entities, such as life insurers, through institutional annuities. It is politically unlikely and structurally unreasonable to assume that public plan sponsors can reduce risk by closing or terminally funding their plans to current employees.

The implementation of liability-matching investment strategies, however, and risk transfer through a systematic and disciplined process would allow plans to increase funding rates, secure funding for current liabilities without incurring investment losses and increase sustainability. Let’s look at how these two approaches would work in the context of a defined-benefit plan.

**Liability-driven investing**

Public defined-benefit pension plans traditionally have attempted to manage investment risk and returns by allocating between stocks and bonds, usually with a 60% equity and 40% fixed-income model. More recently, use of alternative asset classes has increased.

Sole adherence to a 60/40 investment approach, combined with a requirement to increase returns, creates substantial volatility in contributions needed from the sponsor to meet current liabilities. A move to immediate-recognition and more transparent accounting and a stronger emphasis on how funding levels and liabilities affect bond ratings is prompting public plan sponsors to reduce funding status volatility and seek stable funding rates.

A major component of a risk-reduction strategy is immunizing a portion of the plan’s assets against its liabilities, ensuring that cash flow is available for payment of current liabilities. This process uses assets with the same duration as the plan’s liabilities. Those assets often include high-quality bonds, guaranteed investment contracts, zero coupon bonds, certificates or deposit or other period-certain maturity investments. These assets mitigate the volatility of the plan’s longer-term investments.

**Retiree risk transfer**

Risk transfer to insurers has been effectively used by corporate pension plans to eliminate retiree liability. Recently, both General Motors and Verizon transferred significant pension-retiree liability risk of $27.1 billion and $8.7 billion, respectively, to Prudential Insurance Company. But the strategy is problematic for two reasons. Pension plans would need to make a designated portion of the plan’s retiree population whole in order to implement a like-kind exchange with the insurers. Due to low funding levels, the current market value of fund assets in the vast majority of public plans is considerably less than the dollar amount required to do so. Secondly, the typical public plan sponsor can theoretically raise taxes to an unlimited extent in order to fund the liabilities. As a result, extensive litigation on the part of participants in the plans is unavoidable, even though the insurers may carry a higher financial rating than the governing entity.
An alternative to an outright transfer of retiree liability and risk, often used by corporate sponsors, is a pension risk transfer buy-in — a systematic and disciplined dynamic risk transfer to a consortium of high-quality insurers. This is done within the plan. The insurers guarantee annuity and benefit payments as an asset of the plan. The annuity payments become an important component of a risk-adjusted allocation plan by the plan's investment consultant. Furthermore, all or a portion of the annual required contribution (ARC) already mandated and budgeted can be used to purchase the risk-transfer asset.

Furthermore, the budget outlays over and above that mandated by the ARC, which make up the difference between the market value of plan assets and the assets required to purchase the risk transfer, are not necessary. The asset transfers can be accomplished within the plan on a systematic basis over time, aided by prudent investment allocation.

My firm has shown that an allocation of only 10% of the ARC toward the buy-in risk transfer will transfer retiree liability and eliminate the risk of financing retirement benefits for those participants who expect to retire in the next 10 years. This puts the plan on a low-risk path to sustainability. Using conservative assumptions and no increase in future interest rates, our model provides a complete solution for a plan that is 65% funded within 14 to 18 years with no additional outlays beyond the ARC or legislatively mandated amount.

All stakeholders have the potential to benefit from the implementation of these risk-reduction and risk-transfer processes. Current employees do not need to worry about their future retirement benefits, the viability of the plan or threatened benefit changes. Existing retiree benefits are not threatened by plan-sponsor insolvency. Elected officials will have a viable funding solution. And, most importantly, the taxpayer is unlikely to be on the hook for future massive tax increases.

John Hausladen is the CEO of Plan Funding Solutions, a Malvern, PA-based pension consulting firm. He may be reached at jhausladen@PlanFundingSolutions.com

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