Handout Regarding Proposals to Change Atlanta's General Employees' Pension Plan, Accompanying the Testimony of:

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A Few Points on Pension Costs

1. Annual Required Contributions are equal to: Normal Cost + Amortization of Unfunded Liability
2. <u>General Employees' Plan data:</u>
    a. Normal Costs: 15.3% of payroll
        i. This will be fairly stable over time
        ii. Varies with demographics, but not investment returns or funding status
        iii. City Share: 7.6% of payroll
        iv. Employee Share: 7.7% of payroll
        v. Social Security costs 12.4% of payroll (6.2% for each worker/employer)
    b. Amortization of Unfunded: 20.6% of payroll
        i. This item will vary more than normal costs due to investment performance cycles and changes in funding status.
        ii. This figure would have been lower if you hadn't excluded higher paid employees from participating in the plan -- reducing the payroll leads to a higher percent of pay figure to pay the unfunded.
            - Taking active workers out of the plan didn't help with the unfunded liability or amortization costs last time, right?
            - For a fuller understanding, you should understand what it would look like if you offered your DC plan participants a chance to rejoin the pension plan on a prospective basis – the figures may surprise you.
    c. Total city contribution: 28.2% (beginning of year) or 29.3% (mid-year), but benefit accruals are only 7.6% of that.
3. Retirees are most expensive, followed by older workers. Young workers and new hires are very inexpensive.
    a. Actuaries calculate present value
    b. Deferral period a major factor in present value of benefits on individual level
    c. This is why many studies of plans to put new hires into DC plans show higher costs for at least the first 10-20 years, despite significant benefit cuts.

Basic data for General Employees' Plan

1. The General Employees' plan provides an average benefit of $23,751 to workers and their beneficiaries who spent decades providing services to the community.
2. As you know, these workers do not get social security!
3. This average benefit is low, especially considering that workers are not in social security.
4. Our members are clearly well below average in pay, and thus their benefits are no doubt far less than the average of the entire plan, which is only $23,751.
    a. We would like to know what the average is for AFSCME workers, and would ask that you seek such information. Does $16,000 seem like a reasonable estimate?

    Is this getting rich off taxpayers, or surviving? How much less are you aiming for?

5. For this benefit, workers contribute 7-8% of pay during their entire career – ½ of benefit accrual costs.
6. The plan is designed to pay about 50% of pay to retirees, and based upon the city's own analysis it is quite close to hitting this mark. – *2009 Select Committee Key Findings and Pension assessment Report*
    a. The Select Committee also noted that this target should be HIGHER for lower paid workers.
7. The City's own Pension Assessment Report also shows that:

a. The current benefits are not out-of-line with the city's goals or surrounding jurisdiction's.
b. The DC plan for higher paid workers will fail miserably at providing a secure retirement. This result would be even worse when the plan is implemented for mid-career workers, who won't have time to accrue savings after starting late. See ***Attachment #1***

We do not believe the city should aim for failure in retirement security.

8. Valuation report (page 17): Over 1/3rd of city workers have 0-4 years on the job.
    a. This indicates high turnover in the general plan.
    b. But, many retire with 20 years of service – are they staying once vested?
        i. If so, pension is a great retention tool – countering low pay.
    c. Are you concerned about turnover costs? If not, you probably will when economy recovers.
    d. Often large private firms pay a premium because training expenses can be more costly than the pay premium. -- http://gatton.uky.edu/faculty/troske/publish_pap/restat_sizewage_feb99.pdf
9. In the past 10 years, despite the terrible investment climate and poor funding status, about half the plan's revenues came from employees and investment earnings:
    a. 34% - investment earnings, 14% - employee contributions, and
    b. 52% - city contributions.
    c. Investment returns likely provided even more support to plan funding the prior decade.
    d. Typically, we see 50-70% of plan revenues to come from investment returns.
        i. Trouble here is persistent low funding ratio and poor investment decade.
10. Currently, 64% of the city's $1.48 billion in accrued liabilities are for retirees and beneficiaries. The rest is for past service. Future service for current workers will only cost the plan $182 million.

DB Plans versus DC Plans

1. Pensions are more efficient than DC plans: I know you've heard from experts that DC plans will cost more and provide less, which seems counterintuitive. I will attempt to make this clearer below, and to help illustrate this with an example.
    a. Investment returns:
        i. DB plans achieve higher returns because assets are managed by professional investors that have access to a wide range of investment choices.
        ii. *"The bottom line is that over the period 1988-2004 defined benefit plans outperformed 401(k) plans by one percentage point. This outcome occurred despite the fact that 401(k) plans held a higher portion of their assets in equities during the bull market of the 1990s."*
        iii. *"But the one percentage point shortfall understates the investment problem in 401(k) plans, since an aggregate number does not reflect the fact that more than half of participants in 401(k) plans do not follow the prudent investment strategy of diversifying their holdings."*
            -- *Investment Returns: Defined Benefit VS. 401(k) Plans*, Center for Retirement Research at Boston College - crr.bc.edu/images/stories/Briefs/ib_52.pdf

    b. Lower fees:

        i. Large pension plans have the leverage to negotiate lower fees (as a percentage of assets managed) than we find in DC plans.

    c. Investment strategy in DC plans look better overall than they do individually
        i. Barbell-effect: A DC plan may often have an overall investment mix that is similar to a DB plan, but this obscures the fact that on an individual level investment decisions are often disastrous.
    d. Investment horizons:
        i. A DC plan participant, under ideal circumstances, would be free to invest aggressively during their younger years (when they have little in their account), but
        ii. Must get very conservative near retirement (though, many fail to do so – creating incredible personal risk).
        iii. This is a terribly inefficient design flaw, since the very years when a 401k balance begins to accrue a significant amount of funds is when the person should get conservative. *See **Attachment #2***

2. DB plans are better designed to meet goals
    a. Pools investment risk:
        i. Allows for a long and consistent investment horizon – assuming no plan shut-down
        ii. DC plans have winner/loser effect in market cycles – when someone retires (during the market cycle) will play an enormous role in the adequacy of benefits for that worker.
    b. Pools mortality risk:
        i. Some outlive their savings
        ii. Others will die younger, and the city will have provided a nice inheritance for a city worker's child – which is not what you are trying to provide.
        iii. Very few will take their last payments in their last days
    c. DC plans face 'leakage' problem, where people take money out pre-retirement – See ***Attachment #3*** (Article from Pensions and Investments)
3. If the city closes the plan to new hires:
    a. You will be required to use a much shorter amortization period under GASB rules, which will make the city's short term budget problems much worse – especially given the relationship of the size of the unfunded liability compared to costs of new hires.
    b. You will shorten the investment horizon of the plan over time, forcing conservative investing (thus a lower discount rate), which increases costs.
4. Does anyone here believe that the 401k accident will not end in disaster?
    a. WSJ article attached – See ***Attachment #4***
    b. *"A 2008 Annual Survey of 401k Plan Sponsors by Deloitte Consulting found that 80% of employers believe that 401ks are effective in recruiting employees to come work for them but only 13% believe that the 401k plans they offer will provide retirement security for their workers." -- Secrets of the 401k Industry, Edward Seidle,* President of Benchmark Financial Services, Inc.
    c. If we know this is wrong, why would we pursue it?

While growing up, everyone's mother shares the same bit of wisdom at some point: You don't do something that you know is wrong, just because someone else is doing it.

5. Why did private sector switch to DC plans?
    a. Private sector plans didn't typically share costs in DB plans, as the public sector does
    b. DC conversion was more of an effort to shift costs than lower costs

c. The outcome, retirement insecurity, was a by-product of this effort
d. They must have known that these plans would have been less efficient due to investments
    i. But, it was less important to employers than the cost shift
e. Results are a less efficient design, with higher costs for the same benefit, and most workers followed coworkers (5-10% of pay) advice/actions and will fall short.
    i. Employers didn't want to admit that they had to save a high percentage of pay
    ii. At least they have Social Security to fall back on!
f. They did limit volatility – for their firms. They left that volatility on the workers, who have tremendous disadvantages investing funds compared to their employers.

How Did Atlanta's General Employees' Plan Reach This Point

1. Good plan governance and management is essential to managing the risks in sponsoring a DB pension plan, along with care in setting assumptions.
    a. Good investment performance
    b. Getting assumptions and contribution levels right
2. I heard comments that the plan was invested '80% in bonds' in the 1990's, which explains a bit when I looked back at the plan's funding history. As of December 31, 2008, the plan was roughly 60% in bonds. Does that reflect today's investment mix? What discount rate has been used historically?
    a. If the plan was invested 80% in bonds during the late 1990's, it should not have been using an 8% discount rate.
    b. The discount rate should be based upon actual investment mix – if you want less risky investments, you need to pay a premium via a lower discount rate.
    c. You do not assume 8% because others' do, you assume 8% because your investment mix justifies it. You will never reach full funding by investing in bonds that pay 4-7% and assuming an 8% return on investments.
    d. GFOA Notes: *"Work closely with actuaries and other advisors to determine the plan's expected rate of return (estimated long-term investment yield for the plan, net of fees, <u>with consideration given to the nature and mix of current and expected plan investments</u>), the expected variation or level of volatility of returns, cash needs for several years out, <u>and the expected time horizon for achieving return objectives</u>."* -- link in ***Attachment #5***
    e. This is a major red flag.
3. Salary Scale and CPI Assumptions
    a. Plan assumes annual pay increases of 5.25-9%.
        i. Is this realistic? Pay has not increased at this rate for a long, long time.
        ii. Valuation states that this is based upon inflation of 4.5% plus age-related salary scale
        iii. Last time CPI-U increased 4.5% or more was 1990. Based upon December over December figures, CPI-U has only met or exceeded 4.5% only three times since 1981 (the last 30 years). All three occasions occurred during 1980-1990. The average has been 3.16% since 1980, and the average since 1995 has been 2.41%
        iv. See *Attachment #6*
    b. COLA assumes 3% a year: this is the max, not expected amount. Should be closer to 2.7%, since it will be below 3% at times.
4. Background Plan Data on ***Attachment # 7***

I would highly recommend focusing your attention to pension management 'best practices', which could be more effective at reducing your costs than anything you are considering on the benefit side.

Good News/Bad News

1. Legally it is very unlikely that the mayor's plan is even possible
    a. It seems clear that legal protections in Georgia are strong for current workers
        i. See NCPERS link on *Attachment #5*
    b. We share the legal views expressed by the Firefighter's attorney during their presentation
4. Markets have recovered since June 30, 2009, so the plan is now in better shape.
    a. S&P closed at 919.32 on 6/30/09, but was at 1343.60 on 5/19/2011 – up 46.1%.
    b. Plan assets were $782.4 million on June 30, 2009 – a low point in the investment cycle
    c. Per the April 6, 2011 General Employees Board Minutes: Plan assets have increased to $1.076 billion as of February 2011 – **an increase of 37.5%**. See *Attachment #8*
    d. During this time liabilities have likely increased, but nowhere near 37.5%. In fact, they have increased less than actuaries would project due to three factors:
        i. Pay increases have been less than projected (assumption is 5.25-9.0%).
        ii. COLA's would have been less than assumed (3%)
        iii. Reductions in force since June 30, 2009, while many of the city's new hires since have been added to the city's safety plans.
    e. You really should demand more current information to make such important decisions, as June 30, 2009 is no longer an accurate picture.
5. Pension costs are cyclical: They won't increase on a straight-line basis, as many are implying
6. Plan is nowhere near a liquidity Crisis: Contributions still paying Benefits
    a. Total Contributions (employer and employee) in FY 2009 were $80.7 million
    b. Benefit Payments in FY 2009 were $78.4 million
    c. Plan is at a point where contributions are roughly equal to benefit payments, and investments can be made to increase asset base. The plan is not being drained by benefit payments.
7. 2nd tier options won't help in the short run. (Few being hired, new hire costs low.)
    a. Focus needs to be long-term, structural.

Outcomes of Mayor's plan

1. Legal challenges: Outcome seems clear
2. If plan is ruled legal:
    a. Benefits for current workers are cut severely (Attachment #1)
    b. Benefits for new hires are cut severely, possibly aided by Social Security (Attachment #1) which would add 12.4% of payroll cost
    c. City has a less efficient plan (DB vs. DC, part 1) – lower returns, higher fees, inefficient investment horizons
    d. City has a plan that is more poorly designed (DB vs. DC, part 2)
        i. No longer pool investment or mortality risk
        ii. Leakage problems
        iii. Winners and losers created due to timing of reaching retirement/market cycles and mortality variations
    e. Unfunded Liability must be amortized over a shorter time frame: average working lifetime, instead of 30 years. (DB vs. DC, part 3)
    f. Current plan will have a shrinking investment horizon (forcing conservative investment strategy over time, costing more), employees will stop contributing.

3. If plan is ruled illegal:
    a. Start at square one analyzing pensions, or
    b. Allow plan to take effect for only new hires without properly analyzing the outcome of such a policy
        i. Projected savings would turn into additional costs for next 10-20 years
            - Normal costs for DB plan would increase dramatically as % of payroll as demographics change
            - New hire costs higher for foreseeable future

Benefits and Drawbacks of a Hybrid System Using Social Security for a New Tier

1. Benefit: Limits volatility in city contributions (more stable and predictable)
2. Drawback: Cost much more for the same dollar of benefit
    a. Your plan has a multiplier of 2.5% for 15.3% of payroll – replaces 50% of income after 20 years
    b. Social security costs 12.4% (6.2% employer and employee) for a multiplier of 1-1.1%
        i. Social security replaces about 40% of income on average after full career
    c. Prefunding and use of investment returns are source of cost advantage
3. Benefit: Progressive benefit formula inherent in social security
4. Benefit: For workers who spend part of their service in Social Security, then work for the city, the Social Security benefit erodes over time now (due to many years outside the system, the average career pay never increases). Adding workers into the system adds continuity to Social Security participation.
    a. What is average age of a new hire?

You are a Major Player in Setting Local Labor Market Standards

1. City is a major employer, with thousands of employees, and competes with large employers for talent
    a. They take your pay and benefits into account when setting their compensation
2. Do other major employers in the area still offer a DB plan?
    a. Do you think their HR offices will take note of what happens here?
    b. They should, and I suspect they will.
3. You could end up cutting more pensions than you realize.
4. Again, the community standards would be lowered in the name of *helping the citizens of the city.*

Wrap-up and Our Thoughts on Reform Options

1. Our understanding is that the legal protections prevent cuts to current workers.
2. Any reforms should be based upon the most accurate, and recent, information available.
    a. Council should consider expedited June 30, 2011 valuations that would help with decision making considering dramatic changes in plan assets and any questions you may have regarding assumptions used in that valuations.
    b. You should also look into plan management practices more generally, which could affect the city's finances far more than new hire costs or future service costs, since a large liability and pool of assets already exist. Retirement board needs right incentives.
    c. An experience study would be appropriate at a time like this to assure that you are comfortable with the data upon which you are relying.
3. I haven't heard many complaints here of pension spiking, reclassification or other abuse practices. We would be willing to fix such issues, but I'm not sure that is relevant in this case. OT excluded, 80% of pay cap on benefits...
4. We are willing to look at new hire changes, more to help city manage volatility than to slash benefits. We don't see current benefit levels as excessive, but merely what is necessary.
    a. We would consider supporting a hybrid with a less generous DB plan coupled with social security, though we have concerns and believe that it would cost more to lessen volatility in this manner.
    b. It could also affect employee contributions to current plan, driving up city costs, if new hires would contribute toward for less generous plan
5. We would also consider benefit designs that would limit volatility based upon funding status for new hires, provided we could be comfortable with plan management issues. We are not comfortable with these issues today.
    a. We would be much more willing to accept changes generally, if these issues are taken seriously.
6. We do not believe the benefit formula produces a rich benefit for our members, and are obviously concerned with benefit adequacy. We would like to discuss items that are beneficial to the city and acceptable to our membership. However, slashing a pension formula that produces average benefits of $16-24,000 today should not be a priority when these workers don't accrue Social Security.
7. Typically, I would rather see our members pay more toward our benefits (at least in the periods of high costs), than to see retirement security sacrificed.
    a. That is difficult to support here, given our concern over pay levels for our members – which many of you seem to share.
8. We see the options in the Mayor's proposal as extremely detrimental to the economic security of our members and a path toward a less efficient system for tax payers. Further, we ask that you be fully aware of how proposed plans affect various workers at different pay levels – not just the average member.
9. Moving workers to a DC plan, without social security, is an absolutely terrifying proposal – especially for lower paid workers.