SAVA Legislative Interim Committee Meeting
Friday, April 21, 2006
Roxanne M. Minnehan, MPERA Executive Director
Testimony

1. Comments on Principles & Guidelines for Montana's Public Employee Retirement Systems [Dave Bohyer, Legislative Services Division, April 21, 2006]
    - ➤ *Public Pensions A Legislator's Guide* NCSL, May 1995 provides sound background information re:
        - ▪ Principles of Pension Policy
            - Pensions should provide financial security in retirement
                - o At completion of working career provide a minimum benefit rewarding years of public service
            - Pension funding should be a contemporary obligation
                - o Retirement benefits should be paid for at the time the service is performed not by future contributors or taxpayers
            - Pension investments should be governed by the "prudent **expert** rule"
                - o Standard for due diligence, care and skill which other prudent experts would exercise in a like position
            - Pension benefits should be equitably allocated among beneficiaries
                - o prevent discrimination between retirement systems and among members of the same system
        - ▪ Recommendations for Policy
            - Retirement Boards and Lawmakers (Governor's office and legislature) need to be educated, well-informed of the systems' funding situation and other issues
            - Need to work together to address the issues to establish sound policies for recruitment and retention of government workers and provide sustainable retirement income

2. Public Employees' Retirement Board's (PERB) Principles & Guidelines

[Attachment A]

- ➤ PERB Mission Statement

  PERB's Mission statement reinforces compliance with the legal and fiduciary responsibilities.
    - ▪ Montana Constitution (Article VIII, Section 15) requires:
        - Public retirement systems to be funded on an actuarially sound basis; and
        - The PERB to administer the systems as fiduciaries for participants.
    - ▪ Montana Code Annotated (§19-2-405 (4) (a), MCA) requires:

- The unfunded actuarial liabilities of the retirement plans be amortized within 30 years.

[Attachment B]

- PERB Funding and Benefit Policy (BOARD Admin 01, 5/27/04)
  PERB's funding policy provides general guidelines, reinforcing PERB's mission statement.
  - Policy & Objectives
    - Statement of PERB's responsibility
    - BOI charged with investing retirement systems' assets under the "prudent expert principle"
  - General Principles
    - Provides consistent evaluation of proposed legislation
      - Enhancements include a funding mechanism
      - Funding is a contemporary obligation – ensure costs are not shifted to future members.
      - Goal to provide financial security.
      - Portability between systems by paying actuarial costs
      - Equitability
      - Consistency
      - Promote education, communication and evaluation
    - Provide financial solvency
      - Goal to become fully funded
      - Review funding levels when funded ratio is excess of 120%
      - Responsibility to report financial solvency to the Legislature and make recommendations

[Attachment C]

- Retirement Legislation Decision Points
  - This document provides a matrix checklist
  - Provides a visual to assist PERB in determining if the proposal meets the guidelines.

[Attachment D]

- Gabriel, Roeder, Smith & Company/National Association of State Retirement Administrators (NASRA) joint letter to Michael H. Moskow, President and CEO, Federal Reserve Board of Chicago
  - This letter addresses the concerns about public pension funding and the future of retirement benefits. It supports sound public policy in dealing with retirement issues.
    - 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.

- Increased unfunded actuarial liabilities are usually amortized through increases in employer contribution rates.
- Fallacy that replacing defined benefit plans with defined contribution plans is effective in reducing government costs or better at meting the needs of the workers.
    - The Federal & State constitutions have strong legal protections on retirement benefits. Defined benefit plan still needs to be funded for the current membership.
    - Closing defined benefit plans to new hires increases the annual required contributions to the defined benefit plan.
- Broader economic implications as more people retire and the need for sufficient sustainable retirement income to support the economy.
- Steps to improve plan sustainability
    - Reduce downside investment risk by reviewing asset allocations
    - Avoid providing benefit increases without funding
    - Consistently contribute the amounts necessary to fund the plans
    - If benefits cannot be sustained establish new tiers

The Montana Public Employees' Retirement Board will fiduciarily administer its retirement plans and trust funds, acting in the best interest of the members and beneficiaries.

PERB Mission Statement

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Attachment A

MONTANA PUBLIC EMPLOYEES' RETIREMENT BOARD

TITLE: Funding and Benefit Policy

POLICY NO: BOARD Admin 01 EFFECTIVE DATE: 5/27/04

I. POLICY AND OBJECTIVES

The Public Employees' Retirement Board (the Board) has established the following general principles governing the funding and benefits of retirement systems under its jurisdiction. This policy is only a statement of intent and general approach. These are not precise rules that bind the Board to certain and specific actions.

It is the mission of the Board as fiduciaries to administer its retirement systems and trust funds acting in the best interests of the members and beneficiaries.

A. The Board is charged with administrating the retirement systems in accordance with the provisions of Title 19 of the Montana Code Annotated. The Board is required to approve or disapprove all expenditures of the systems, prepare a biennial actuarial valuation of the assets and liabilities of the systems, and perform other duties and functions as are required to properly administer and operate the retirement systems.

B. Board members are subject to a constitutional fiduciary duty to fund retirement benefits, Article VIII, Sections 13 and 15 of the Montana Constitution. The Constitution prohibits anyone from diverting the assets or the actuarially required contributions of the retirement systems. No employee or member of the retirement systems may have an interest in plan assets, borrow or use fund assets, or act as surety, obligor or endorser on loans to or by the systems.

C. The Montana Board of Investments (BOI) is charged with investing the Board's retirement systems' assets in accordance with state law and the state Constitution. The Constitution requires that the Board and the BOI operate under the "prudent expert principle". The Board's retirement systems have long-term horizons well beyond normal market cycles.

D. The future investment earnings of the assets of the retirement systems are assumed to accrue at a net annual rate of at least 8.00% over time, net of all administrative and investment-related expenses.

Attachment B

II. GENERAL PRINCIPLES

These general principles are established by the Public Employees' Retirement Board to provide a framework for the consistent evaluation of legislative proposals. The Board's position on proposed changes to benefits or systems will be determined on a case-by-case basis using these principles as guides. Some principles may not apply to the Public Employees' Retirement System's Defined Contribution Retirement Plan.

A. Legislation

1. **Proposals for increases or changes to retirement benefits must include an actuarially sufficient funding mechanism.** Proposals must provide funding from sources sufficient to cover future costs and to amortize any unfunded liabilities created by the proposal over a period of time appropriate to the retirement system, but not more than 30 years.

2. **Pension funding should be a contemporary obligation.** Whenever possible, pension funding should be the responsibility of the public employers, taxpayers and employees at the time services are provided. The Board will promote advanced funding of all benefits to ensure costs are not shifted to future taxpayers or contributors.

3. **Benefit enhancements should be equitably allocated among active members and retirees.** Any increased cost should be distributed among the generation of employers, taxpayers, and employees who receive the greatest benefit. Proposals should not discriminate against certain groups of members or retirees in favor of others or expend system assets disproportionately.

4. **A primary goal of a retirement system must be to provide financial security in retirement.** "Financial security in retirement" refers to basic financial protection for those who are beyond their normal working years and whose ability to be gainfully employed and earn other income is limited or non-existent.

5. **Public retirement plans should provide portability of benefits for workers who change jobs within the state and its political subdivisions.** Portability provisions must assure that actuarial costs will be paid for when transferring service between the systems.

6. **The level of benefits and eligibility for benefits should be equitable across the state's public employee retirement systems.** Differences in benefit levels and eligibility criteria should be based on objective differences in the nature of the covered occupations or differences in coordination with other benefits such as social security.

7. **Proposals should promote consistent administration of public retirement systems.** The Board promotes consistent administrative provisions between the public retirement systems.

8. **The Board supports steps to improve the Board's ability to evaluate and review disabilities and the eligibility for disability benefits.**

9. **The Board supports steps to promote informed legislative involvement and decision-making in the formulation of Montana's public pension policy.**

B. Financial Solvency

1. **It is the goal of the Board that the retirement systems it administers become fully funded.** Once a system has achieved this goal, there needs to be a range of safety to absorb market volatility without creating unfunded actuarial liabilities. Surplus funds that may become available may be applied toward the cost of benefit enhancements and/or contribution reductions provided sufficient reserves are retained to reasonably allow for adverse experience.

2. **The Board will review existing funding levels for retirement systems with a funded ratio in excess of 120%.** The Board will consider a wide range of factors, both historical and prospective, in determining the range of safety required.

3. **It is the responsibility of the Board to report the financial solvency of the funds to the Legislature.** A single year's funded ratio, by itself, does not provide a measure of the direction the funding of the system is headed. However, either a trend which results in decreasing the funded ratio or the inability of the system to reduce the amortization period by one, for each passing year, may cause the Board to consider recommending rate increases. It is desirable that the funded ratio improves over time, allowing for a decrease in the ratio following benefit enhancements.

4. **It is the obligation of the Board to recommend funding increases.** Whenever, through the use of long term cash flow projections, the amortization period of a system's unfunded liabilities is projected to exceed 30 years for two consecutive valuations and the Board can not reasonably anticipate that the amortization period would decline without an increase in funding sources, it is the obligation of the Board to recommend to the Legislature that funding be increased.

III. CROSS REFERENCE GUIDE

The following laws, rules or policies may contain provisions that might modify a decision relating to the Funding and Benefit Policy. The list should not be considered exhaustive - others may apply.

Montana Constitution Article VIII, Sections 13 and 15
Section 19-2-303, MCA
Section 19-2-403, MCA
Section 19-2-405, MCA
Section 19-2-408, MCA
Section 19-2-409, MCA
Title 19, Chapter 2, Part 5, MCA
ARM 2.43.304
Board Policy O8-93 Actuarial Studies
Board Policy O1-01 Actuarial Assumptions

IV. HISTORY

G9-92 General Principles Governing the Board's Evaluation of Legislative Proposals
Originally approved September 1992
Amended March 24, 2005
O8-93 Actuarial Experience Studies
Originally approved August 1983
To be Amended
O4-94 Actuarial Assumptions
Originally approved April 1994
Amended December 27, 2000 (O1-01)
O1-01 Actuarial Assumptions
To Be Amended

Retirement Legislation Decision Points

Procedural Factors	**Yes**	**No**	**Explanation**
Was the retirement Board informed of the proposal in detail, with time enough for actuarial analysis?			
Has the retirement Board actuarial analysis been completed?			
Has the proposal been approved by the legislative interim committee?			
Has an actuarial fiscal note been prepared and considered?			
Objective	**Yes**	**No**	**Explanation**
Is informed legislative involvement and decision-making in the formulation of Montana's public pension policy promoted?			
Does the proposal promote consistent and efficient administration of a public retirement system?			
Is the goal to provide financial security in retirement?			
Is a management objective proven to be met (such as recruitment or retention)?			
System Design Factors	**Yes**	**No**	**Explanation**
Actuarially sufficient funding mechanism?			
Is funding a contemporary obligation?			
Are benefit enhancements equitably allocated among active members and retirees?			
Does the change promote portability of benefits for workers who change jobs within the state and its political subdivisions?			
Potential Design Flaws	**Yes**	**No**	**Explanation**
Will the change promote early retirement?			
Will the change increase working retirees or increase the hours working retirees can work?			
Will the demographics (such as member age and years of service) of the system be changed?			
Can the member receive service for less than actuarial value?			
Is this an *ad hoc* benefit increase (not pre-funded by pension fund earnings)?			
Is High Average Compensation artificially inflated?			
Is funding delayed?			

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Amendment A.

GRS

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

Attachment D

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]

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[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]

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[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

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[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.

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[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/persfundingrp.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,

Keith Brainard

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