The Iowa Policy Project
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EXECUTIVE SUMMARY

Public Pensions in Perspective

Why Foundations of Iowa, Many State Pension Systems are Strong

A stable and durable public pension system, efficiently managed and funded, is important to employees, employers, the state, and the economy. Workers seeking a secure retirement, employers concerned about attracting and retaining a qualified, loyal workforce, and policy-makers seeking economic stability all have an interest in maintaining a healthy retirement system.

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Our study finds that in Iowa and most states, public-sector pension systems remain strong and healthy, meeting pensions' important role in assuring retirement security to working Americans.

Along with Social Security and personal savings, defined benefit pension programs became a foundation of the 20th-century U.S. retirement security system that made possible a U.S. middle class and eliminated endemic poverty among the elderly. Today, particularly as many major private sector employers have eliminated defined benefit pension plans, this system has begun to unravel. The result is creating alarming levels of insecurity for current and future retirees.

Pensions are a form of deferred compensation, in which employees agree to work for a certain income, while a portion of their overall compensation is set aside by the employer in an account to be drawn upon at retirement age. Employees accept terms of employment with the expectation that this portion of compensation they have "loaned" to the employer will be returned to them when they retire. In recent decades, however, many private companies and even some public employers have failed to make good on this promise — failing for years to make their share of contributions to retirement accounts, exploiting loopholes in regulatory rules, or using bankruptcy to shed pension obligations.

Against this backdrop of broken promises, even well-managed, sound public sector pension systems like Iowa's have come under attack.[1] Most recently, sensational publicity associated with highly unusual cases of pension underfunding in Illinois and the city of Detroit may have clouded the public perception of public pensions in general. Contrary to those unusual cases, we find Iowa and most states have generally healthy and well-managed plans that are built to last over the long term.

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As private sector pensions disappear, some have also questioned whether remaining public pension benefits should be maintained. In reality, prior IPP research shows that even when benefits (pension and health insurance) are taken into account, Iowa public sector employees are already *undercompensated* in comparison to private sector counterparts with similar levels of education and experience.[2] Our current research further suggests that Iowa's public pension system is functioning as intended as an efficient, predictable way for public employers to spread risk and affordably share costs of funding retirement for a large pool of employees.

Evidence compiled in this report shows that Iowa's state plans are working well for employees, public employers and taxpayers. Iowa has one large state pension plan covering most state and local government employees and three smaller plans covering (1) police and firefighters, (2) state law enforcement personnel and (3) judges. Stock market downturns at the end of the last decade hit all investors — including public employee pension plans — but these plans have proven themselves to be remarkably durable and efficient. Iowa's public pension plans have sufficient assets to pay benefits now and well into the future. With recent improvements the plans have begun recouping losses incurred during a recessionary stock market.

Indeed, Iowa's public pension systems today serve precisely the chief public purposes — promoting "economy and efficiency" and enabling employees "to care for themselves in retirement" — that the Iowa Legislature intended. These goals are summarized well in the Iowa Code chapter governing Iowa's largest state pension plan, IPERS, established 60 years ago:[3]

> **97B.2 Purpose of chapter.**
> The purpose of this chapter is to promote economy and efficiency in the public service by providing an orderly means for employees, without hardship or prejudice, to have a retirement system which will provide for the payment of annuities, enabling the employees to care for themselves in retirement and which will improve public employment within the state, reduce excessive personnel turnover, and offer suitable attraction to high-grade men and women to enter public service in the state.

Iowa's state pension systems illustrate the economic and social value of defined-benefit pension plans. Defined-benefit plans are guaranteed by design to achieve the chief purpose of a pension: to assure a secure benefit to a person in retirement. By contrast, defined-contribution plans (e.g., 401ks) and individual retirement accounts place that security at risk.

- Section 1 of this report explores the financing of pensions, examines the structure of pension plans, and explains the variables that are used in defining the financial health of plans. It offers an understanding of the concept of "unfunded liability" often skipped in political rhetoric.
- Section 2 looks in detail at Iowa's four main public pension plans: their background, governing structures and overall financial health. The section shows how both employer and employee contribute to these pensions. It also shows that in Iowa the employer does not always contribute adequately to deliver the promised benefit since it is not legally required to do so.
- Section 3 compares IPERS to similar plans around the nation. It concludes Iowa's plans are among the strongest. In many cases, recent improvements have already begun shoring up plans that faced funding challenges. This section also recommends areas for further improvements.

Financing Pensions: Defined Benefit vs. Defined Contribution Plans

The purpose of a Defined Benefit (DB) pension plan is to pay a known and "defined" annual benefit to an employee for the duration of his/her retirement. The goal of a pension system is to provide a secure retirement, and this requires an adequate monthly income over the individual's lifetime, no matter how long. That is what a DB plan is designed to accomplish.

In contrast, Defined Contribution (DC) plans, more common in the private sector, establish the annual contribution into the individual's retirement account; there is no guarantee that the account will be sufficient upon retirement to provide an adequate annual income. The size of the employee's account at retirement is entirely dependent on the way it was invested and the ups and downs of the stock and bond markets during the employee's working life. While an individual could purchase a lifetime annuity with the amount in his or her account upon retirement, that means the individual's lifetime income during retirement depends on whether the stock market is up or down at retirement. Retirement during a recession or long bear market means the annuity may be far less than needed.

A DB plan is an inherently more efficient way to provide retirement benefits. The monthly contributions per employee to provide a given level of retirement security are less because the risk of longevity — the risk of outliving one's income — is pooled across a large number of workers. If the average worker will collect a pension for 15 years, then the contribution for each worker need only be sufficient to provide the average pension — 15 years of benefits. Yet the fund as a whole will still be able to guarantee everyone a lifetime pension because those who collect for fewer than 15 years will offset the cost of those who live longer.

A defined benefit plan is an inherently more efficient way to provide retirement benefits.

Contrast such a pension fund to a DC plan, like a 401k, where everyone has a separate individual account. Who would feel secure with an account sufficient to provide a pension for just 15 years, when one might well live another 15? Much more must be deposited in each worker's account during working years to provide reasonable retirement security. Furthermore, a pension fund is likely to earn a higher return on its investments than the average 401k account as the fund, unlike the individual account, can afford to invest in higher-risk, higher-return securities because risk is pooled, and because the average worker's low level of financial literacy can lead to bad investment decisions. Finally, the cost of managing a large pension fund is much less per retiree than the cost of managing an individual account, so the contributions to the 401k accounts must include the higher management fees.

Pension Funds: Fully Funded Vs. Underfunded

A new employee has not yet accrued any pension benefits. Over time, however, he/she starts to accrue these benefits, which increase with each additional year worked, to a point. From the employer's perspective, these benefits are a liability (a promise or obligation to pay someone else). To cover this future liability, annual contributions are made to the fund by the employer (and also the employee).

Because *actual* payment on retirement benefits does not have to be made until retirement day, the pension system can remain underfunded for some time and the amount by which it is underfunded is denoted by the ***Unfunded Actuarially Accrued Liability (UAAL)***. The reason for the UAAL might be that the employer neglected to pay the full share of the required employer contribution in cash. It might also be that the investment income did not grow as expected. Regardless, just as someone may miss a mortgage payment, missing a normal cost payment or not transferring the full amount of cash associated with the normal cost means future payments must rise to account for lower payments of the past.

Unfunded liability is not the lone barometer of the health of a pension system. As long as a plan meets the funding needs of the system over the long term, this unfunded actuarial liability has no negative impact on the long-term funding progress of the retirement system. All that is required for short-term solvency is for a retirement plan to have enough assets, at current market value, to pay off the total benefits as they come due each year. Unfunded liability does not require drastic and immediate actions to reduce it or pay it off. It is "paid down" the same way a home mortgage is paid off. Each year the sponsor's contribution includes a payment to pay down the unfunded liability. The health of the plan, therefore, is tied to its sponsor's ability and willingness to make this minimum required contribution.[4]

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Public Pension Funds: Underfunded, but a Solid Foundation

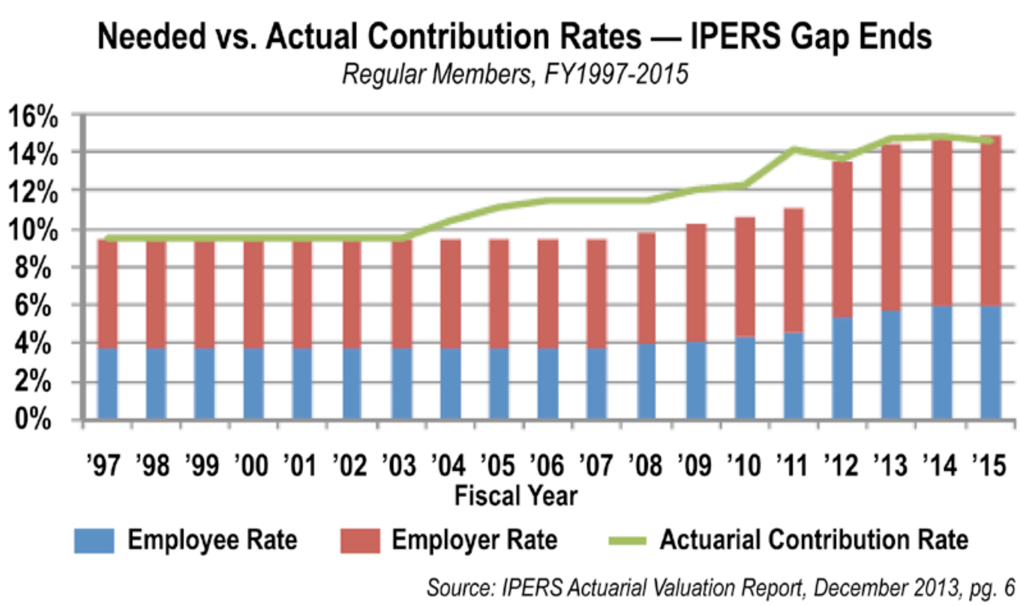
The past decade was not kind to pension plans of any variety, defined benefit or defined contribution, public or private. Pension shortfalls were caused in substantial part by the 2001 recession and the recession of 2008.[5] Both public pension plans and private 401k plans invest heavily in the financial markets and rely on them to produce financial value. Public employee pension plans are durable and efficient and, over time, they can recover their losses. Some state plans that did not make adequate pension contributions face bigger issues today, but in the past few years, all states have moved to change contribution rates and benefit levels.[6]

One way states deal with economic downturns or fiscal shortfalls is to cut back on what they might consider to be non-urgent expenditures. Unfortunately, for state pension plans this often means that state employers do not always make the required payments to amortize their growing liabilities, resulting in the growth of unfunded accrued liabilities. State plans in general and IPERS in particular experienced this trend over the past decade. The stock market declines during the financial crisis and recession played a significant role in raising unfunded liabilities in fiscal years 2009 and 2010. But investment changes do not tell the whole story. We note the pervasive influence of contributions not meeting the required contributions on UAAL.

Solid Foundations of Public Pension Plans

What suggests that public pension plans have a solid foundation? First, there is no immediate shortage of funds to pay benefits, though they are still recovering from the devastating effects of a stock market collapse. Collectively they held almost $3 trillion in assets and have recouped almost two-thirds of the $ 0.9 trillion that they lost in the stock market in the most recent downturn. Even with no further contributions to state funds from now on, it is estimated they could fully pay all retirees for close to 30 years. That suggests public funds have breathing room to make reasonable and gradual adjustments.

Like other state plans, IPERS has no cash issue. Net assets in the IPERS portfolio also have made a good recovery, and have nearly returned to 2007 levels.[7] This allows IPERS considerable time to systematically address issues of underfunding. As a result of recent changes, IPERS made its full required payments by 2013.[8] Barring any major changes from the prevailing demographic and economic assumptions, IPERS will be fully funded in less than 30 years. The graph below, from a new report on IPERS valuation, shows a multiyear gap between the actuarial required contribution rate and actual contribution rates has closed and is projected to remain on track this year and next. And the process suggests a political will of both the state employer and IPERS members to move toward full funding in the long run.



Conclusion and Recommendations

Iowa lawmakers 60 years ago stated their belief about the importance of pensions: the need for a viable retirement plan to help attract qualified people to public service in the state, and enable those people to care for themselves in retirement. Iowa's public defined benefit plans provide a less costly and more efficient way of structuring a retirement system because they allow greater pooling of risk among the participants. Despite a turbulent decade, the foundations of all four Iowa public pension plans remain strong. These foundations, based on strong asset values and a low debt to state income ratio, allow for restructuring to be gradual and inclusive.

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We recommend:

- Iowa, with one of the lowest percentages of state expenditures devoted to pension plans, can increase its overall expenditures devoted to these pension plans.
- The state should make every effort to meet its actuarially recommended contribution (ARC).
- The present value of pension liabilities should continue to be calculated at the actuarially determined discount rates based on experienced long-term returns in the investment portfolio.
- The state should renew its commitment to the MFPRSI fund by re-starting its contributions at the 3.79 percent level.
- Future increases in contributions should be shared on a 40 percent to 60 percent basis between employees and employers.
- When changes are made, plans should ease members through the process with effective and timely communication.
- Incremental steps to "course-correct" are more effective than quick fixes because of the long-term nature of a pension system.

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[1] Tegeler, Gretchen, "Iowa View: What's the state of our state's pension system?" *The Des Moines Register*, September 28, 2013.

[2] Cannon, Andrew, The Iowa Policy Project. "Apples to Apples: Private-Sector and Public-Sector Compensation in Iowa," February 22, 2011. http://www.iowapolicyproject.org/110222-pubpvtpayxs.html

[3] CHAPTER 97B IOWA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (IPERS), https://www.legis.iowa.gov/DOCS/ACO/IC/LINC/Chapter.97b.html

[4] Florida Public Pension Trustees Association, (2011), pg.7

[5] McNichol, Elizabeth, and Iris J. Lav, Center on Budget and Policy Priorities, "A Common Sense Strategy For Fixing State Pension Problems in Tough Economic Times,"(May 2011), (http://www.cbpp.org/cms/index.cfm?fa=view&id=3492), Accesses on November 30, 2012 pg. 1

[6] Twalker, "Four Things You Need to Know about the Pension "Crisis"," Neatoday, (March 17, 2011) http://neatoday.org/2011/03/17/four-things-you-need-to-know-about-pensions/

[7] Iowa Public Employees Retirement System, " Fiscal Year 2013: Budget Briefing." November 23, 2011. <http://www.ipers.org/publications/misc/pdf/legis/2011fy13budgettogovfinal.pdf>

[8] Cavanaugh Macdonald Consulting, LLC, *IPERS Actuarial Valuation Report as of June 30, 2013. pg.11*, http://www.ipers.org/publications/misc/pdf/financial/fy2013valuation.pdf