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State of the States

Update on the Economic Impact of Current Trends for States

March 12, 2024

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Learning Objectives

At the end of this session, you will be able to:		
Recognize different types of pensions and their benefits and their drawbacks	Identify how pensions are affected by the economy	Identify the impact of pensions on the local economy and communities

Recognize Different Types of Pensions and Their Benefits and Their Drawbacks

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What is a Pension?

A pension is a retirement arrangement in which employees receive a regular payment from their employer after retirement in exchange for their years of work

Pension Plan Design

Plan design refers to the framework of a retirement plan

- Participation requirements (mandatory or optional)
- Vesting requirements
- Benefit levels
- Required contributions by the employer and employees
- Methods of benefit distribution
- And others

Defined Benefit Plan (DB)

Provides workers, upon attainment of designated age and service thresholds, a monthly benefit based on the employee's salary and length of service

Accumulated contributions and investment earnings are used to pay the member a monthly pension for the life after retirements

"Defined" portion of the DB plan is the benefit that is guaranteed when participants retire

For *example:*

An employee retiring with a final average salary of $80,000 with 20 years of service, participating in a plan with a 2% retirement multiplier would be eligible for an annual pension benefit of $32,000 ($80,000 x 20 x .02).

Defined Contribution Plan (DC)

Employer provides a retirement savings vehicle for its employees, and typically contributes to the employee's retirement account

Individual account that can be accessed after the member retires

"Defined" portion of a DC account is the contributed amount, not the amount that will be paid out in retirement

No single design will address the *cost and risk factors* of every state or local government

- Nearly every state has made changes in recent years to their retirement plans
- Defined benefit plans remain the most common for government retirement plans, but hybrid plans are gaining popularity
- There is a wide variety of retirement plan designs out there

Advantages and Disadvantages for DB Plans

Advantages

- Provides guaranteed lifetime income to retirees
- Motivates employees to continue in service
- Outside service credit may be recognized
- Cost-of-living protection after retirement may be provided
- Investment management fees typically lower than DC plan

Disadvantages

- Not designed with portability in mind
- Difficult for employees to understand how much the employer is contributing on their behalf

Advantages and Disadvantages for DC Plans

Advantages

- Contribution amount is easily determined and usually constant from year to year
- Account balances may be transferred to next retirement plan at termination
- Opportunity for higher benefits if financial experience is superior

Disadvantages

- Financial risk of outliving accumulated assets
- Financial risk of poor investment return
- Retirees are more likely to take a lump-sum benefit than a periodic payment for life

Hybrid Plans

Includes elements of both DB and DC plans to generate participants' benefit upon retirement

Form of risk-sharing plan design that allocate risk between employers and employees. Public retirement plan risk exhibits primarily in three forms: investment risk, longevity risk, and inflation risk

Common hybrid plan designs:

- Cash balance plans
- DB –DC combination plans

Cash Balance Plans

- Elements of traditional pensions and individual accounts
- Usually, employees on a “notional” account where both member and employer contributions are deposited
  - Accounts are pooled for investment purposes
- Accounts accrue an interest rate specified by the plan (not lower than zero, and typically between four and seven percent)
- Future cash balance is somewhat uncertain, as it depends partly on future investment performance

Cash Balance Plans

(Continued)

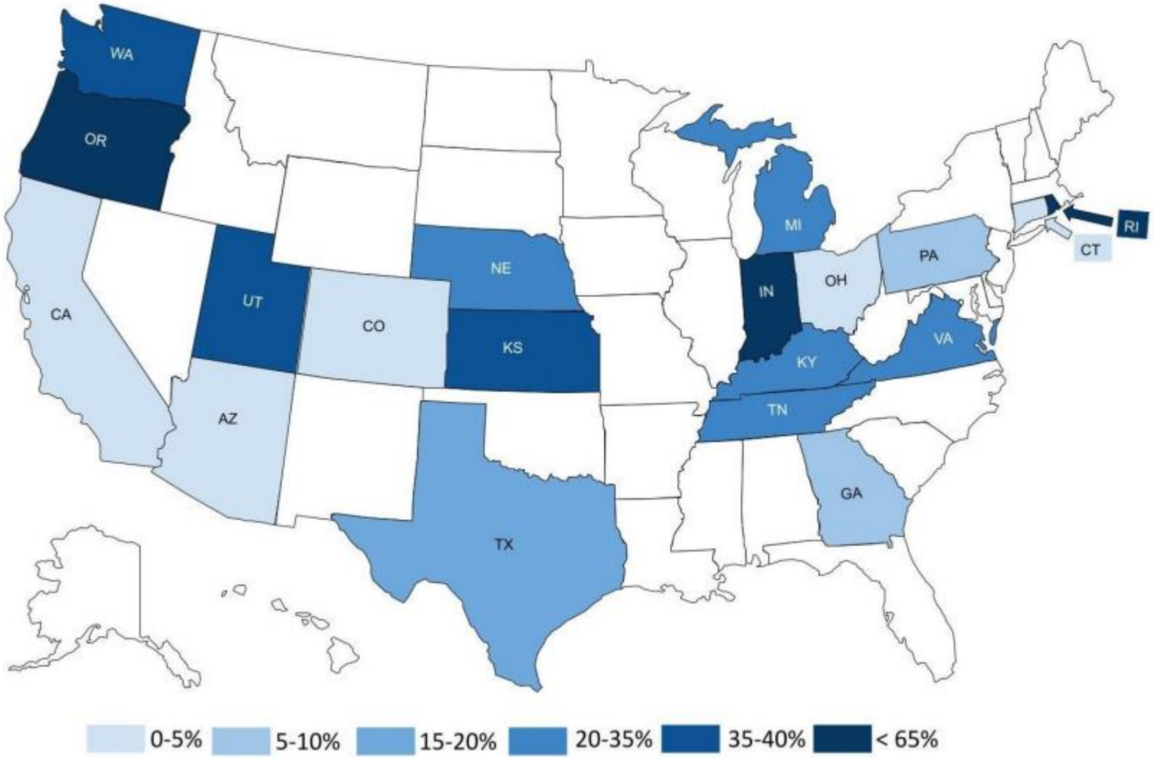
- After retirement, depending on the plan design, any portion of the member's notional cash balance account can be converted into an annuity, which is a fixed monthly benefit guaranteed for life
- The annuity value is dependent on the size of the cash balance account and the discount rate used
- Retirees in payment status may be eligible for benefit increases (COLA's) based on plan's investment performance

Two accounts

DB-DC Combination Plans

Traditional DB plan account typically funded by employer contributions	Individual defined contribution retirement savings account typically funded by member contributions:
	• Usually mandatory or default participation • Typically, more strict rules around member contribution rate changes than what we see for 401(k)’s • At retirement, this member contribution account could be used to purchase a higher annuity or is more flexible on withdrawal at retirement than a traditional DB account

Percentage of Public Employees Who Participate in a Hybrid Plan



Source: NASRA Issue Brief: State Hybrid Retirement Plans June 2022

Identify How Pensions are Affected by the Economy

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Key Economy Impacts

Pressure to keep contribution rates down from employers and state lawmakers in times of financial pressure

Large increase in baby boomer retirements adding strain to pension operations and payments

High inflation rates creating pressure to approve COLAs for retirees

2008 recession sparked a shift toward pension reform

Cost-of-living adjustments (COLAs) - Pennsylvania

2002

Last approved COLA by the PA General Assembly was in 2002 for SERS and PSERS annuitants (over 20 years!)

Nov. 2023

PA House passed HB 1416 in November 2023, which would provide a COLA of 15%-24.5% for SERS and PSERS annuitants that retired prior to 2002 and haven't received a COLA since 2002

currently

HB 1416 is currently sitting with the PA Senate Committee

Pension Reform Since 2009

Increased employee contribution rate

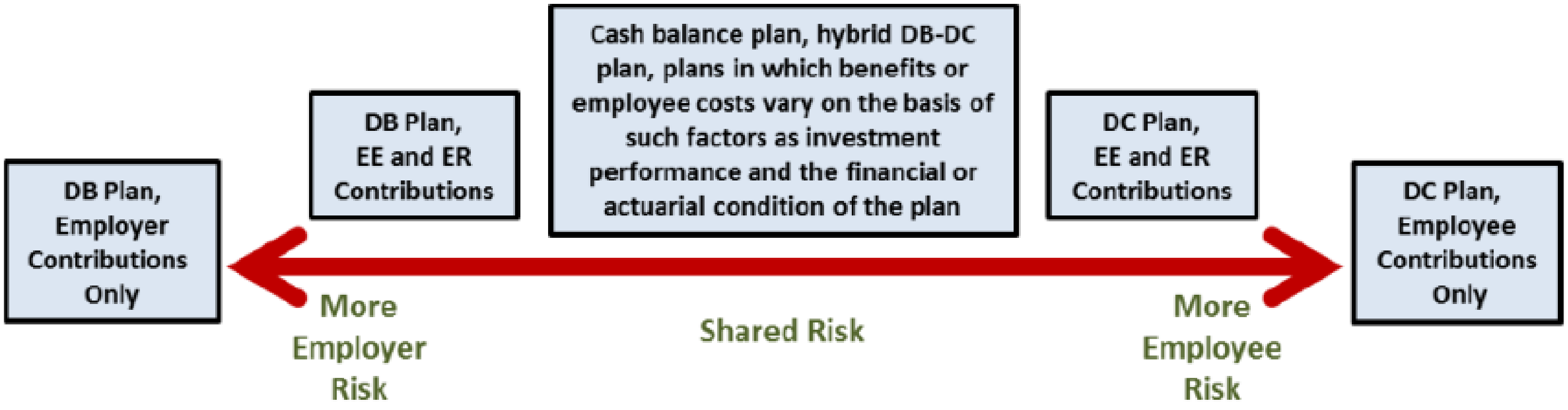
Reduced pension benefits

Reduced automatic COLAs

Established a hybrid plan

Added a risk-sharing plan design feature

Who Bears the Risk in Pension Plans?



Source: Brainard, Keith, and Alex Brown. "NASRA Issue Brief: Shared-Risk in Public Retirement Plans," June 2014. (EE refers to employee and ER refers to employer.)

Risk Assessment

Public pension plans manage a variety of risks, including those relating to investments, operational issues, and the funding or financing of pension benefits

- Stress testing is an analysis or simulation designed to measure the effect on the plan of various projected investment and actuarial events
- Sensitivity testing examines the effect on the plan of different actuarial assumptions and methods

PA Act No. 128, requires annual stress tests for PSERS and SERS

Investment Risk

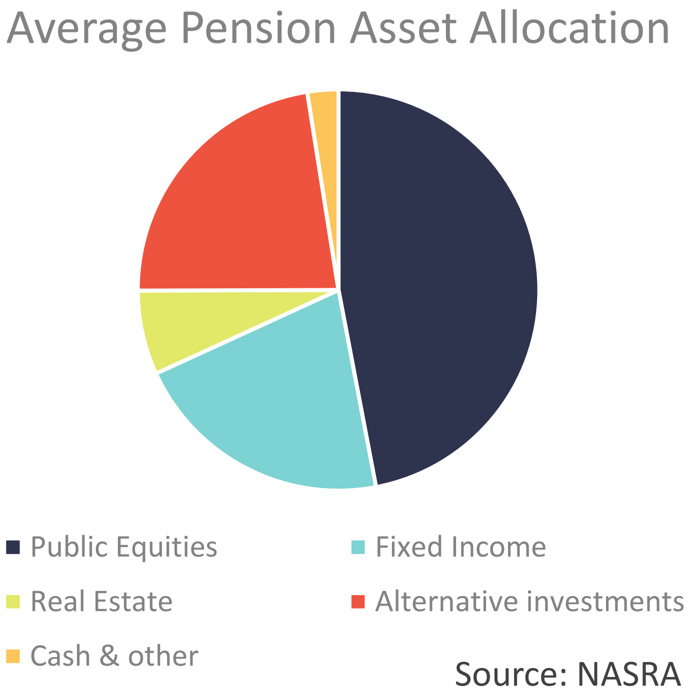
Achieving an investment return in proportion with the inflation rate normally is attainable by investing in high-quality fixed-income securities, such as US Treasuries

To achieve a return higher than the rate of inflation, pension assets are invested in a broadly diversified portfolio, thus taking on more investment risk

- Valuation risk is an emerging concern for public pension funds
  - Risk that currently recorded asset values which are based on valuations, as opposed to market prices, eventually turn out to be overstatements

Investments – Diversified Portfolios

Public pension asset allocations typically are developed as part of a process that considers the plan's liability stream, or projected benefit payments, expected revenue from contributions, and investment earnings



Source: NASRA

Investment Policy is the most important element in the investment structure!

Investment Return Assumption

Investment earnings account for the majority of public pension financing

- Shortfall in long-term expected investment earnings will be made up by higher contributions or reduced benefits

Funding a pension benefit requires the use of projections, known as actuarial assumptions

- Demographic
- Economic

Why is the Investment Return Assumption so Important?

The assumption is used to predict what percentage of future benefit payments will be covered by investment returns and what percentage requires member, employer, and state contributions

An investment return assumption that is set too low will overstate liabilities and costs, causing current taxpayers to be overcharged and future taxpayers to be undercharged. A rate set too high will understate liabilities, undercharging current taxpayers, at the expense of future taxpayers

Investment Return Assumption (continued)

Average public pension plan investment return assumption falls below 7.0%

- Lowest level in more than 40 years

According to Equable’s “The State of Pensions 2023 – October Update”, for State Pensions with June 30 FYE, half exceeded their investment assumption and the other missed their target

- Average investment return of 5.6% (FYE 6/30/23)
- In comparison, 2022 state pensions had an average -5.9%

Investment Return Assumptions (continued)

Projecting public pension fund investment returns requires a focus on the long-term

The recent uptick in the rate of inflation may cause some public pension plans to reconsider their investment return assumption

A key question regarding the future of inflation is whether the recent higher rate will be short-lived, or if inflation will remain elevated for a sustained period

Actuaries consider a long timeframe when setting the inflation assumption

2023 Economic Overview

Continued efforts by the Federal Reserve to control inflation

- In 2023, the Fed raised rates 4 times by 25 basis points each, ending at a rate range of 5.25 – 5.50% (unchanged since July 2023)

Credit markets

- Silicon Valley Bank, Signature Bank, and First Republic Bank

Rebound in public equity markets

- The Magnificent Seven — Apple, Microsoft, Alphabet, Amazon.com, Nvidia, Meta Platforms and Tesla — have driven much of the growth of the S&P 500 index in 2023

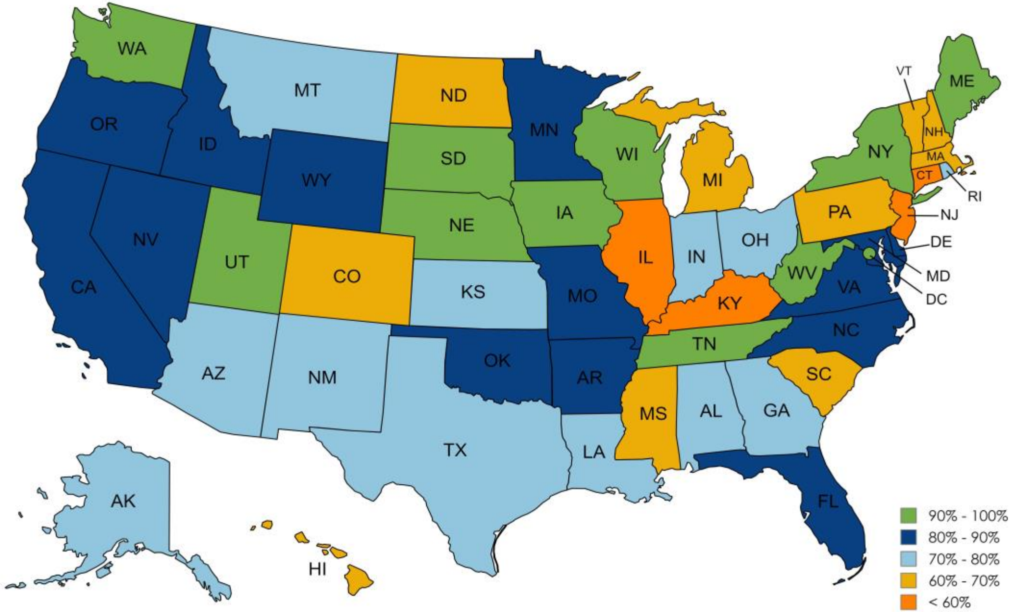
Turmoil in the private markets

NCREIF Property Index One Year Return -7.9%

Credit *Effects*

- The condition of public pensions is a key element in determining the creditworthiness of states and local governments
- Funded status = health report card for a pension
    - Having a well-funded pension also signals to credit rating agencies that the state government has strong financial management practices
- Trend toward more states making payments equal to or greater than the Actuarially Determined Employer Contribution (ADEC) to improve funded status

2023 Estimated Aggregate State Funded Ratios



Created with mapchart.net

Source: Equable – State of Pensions 2023

Environmental, Social and Governance (ESG)

Defined

- Three factors that affect a government's credit profile, including:
  - An exposure to climate risk and other environmental factors (**E)**
  - Long-term social factors **(S)**, and,
  - Governance issues **(G)**

Continuing emphasis on ESG – including legislation aimed to combat it

Environment, Social and Governance (ESG)

- Climate transition risks
- Physical risks
- Natural capital
- Waste and pollution

Environmental

- Health and safety
- Social capital
- Human capital

Social

- Governance structure
- Risk management, culture, and oversight
- Transparency and reporting

Governance

Environmental, Social and Governance (ESG)

Strong ESG characteristics do not necessarily correlate with creditworthiness

The allocation of resources to spending efforts on ESG initiatives could pressure financial performance that could lead to a credit outlook change

Relatively few retirement plans in the U.S. incorporate ESG principles into their investment process

Identify the Impact of Pensions on the Local Economy and Communities

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Impacts of Pensions on State Employee Workforce

- Mandatory participation
- Limits on using retirement savings for loans
- Competitive benefits = better worker retention
- Reduced turnover with incentives for long-term employment

Impact of Pensions and Retired State Employee Workforce

Stable income for elderly population

90% of workers retire to their home state on average

Stable inflows back to the local economy

Assists with keeping elderly above the poverty line

Allows for family planning to support descendants depending on plan options selected

Economic Impact on Pennsylvania

According to a study by Pensionomics for the National Institute on Retirement Security, the pension benefits received by retirees and spent in the local community ripples through the economy, as one person's spending becomes another person's income, creating a multiplier effect.

Pension disbursements of $13.8 billion in 2020 supported:

111,571 jobs that paid $6.8 billion in wages	$18.9 billion in total economic output ($1.37 pension benefit multiplier)	$2.3 billion in federal, state, and local tax revenue

Current Key Issues Impacting States

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Current Trends and Issues

- Labor shortage and pay inflation
- Preparing for leadership transitions
- Shifts in revenue composition
- Increased regulatory scrutiny and oversight
- Keeping up on tax incentive opportunities
- Opportunity for cash management
- Technology – the rise of artificial intelligence
- Cybersecurity
- Presidential election angst – financial market impact

Post-Retirement Employment

Age 65 has been the magic number when it comes to retirement age, but one emerging trend is that more Americans are working through their 60s and even into their 70s

- Large percentage of baby boomers failed to properly save

As the global population ages, post-retirement employment is becoming increasingly important to potentially reduce costs for public employers and help with projected labor shortages due to an aging workforce

What's ahead for pensions and OPEBs

- Assumption changes and reforms
- Rising contribution rates
- Inflation's long-term effects
- Added headcount and higher salaries
- Retiree health care costs

Questions?

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Thank you!