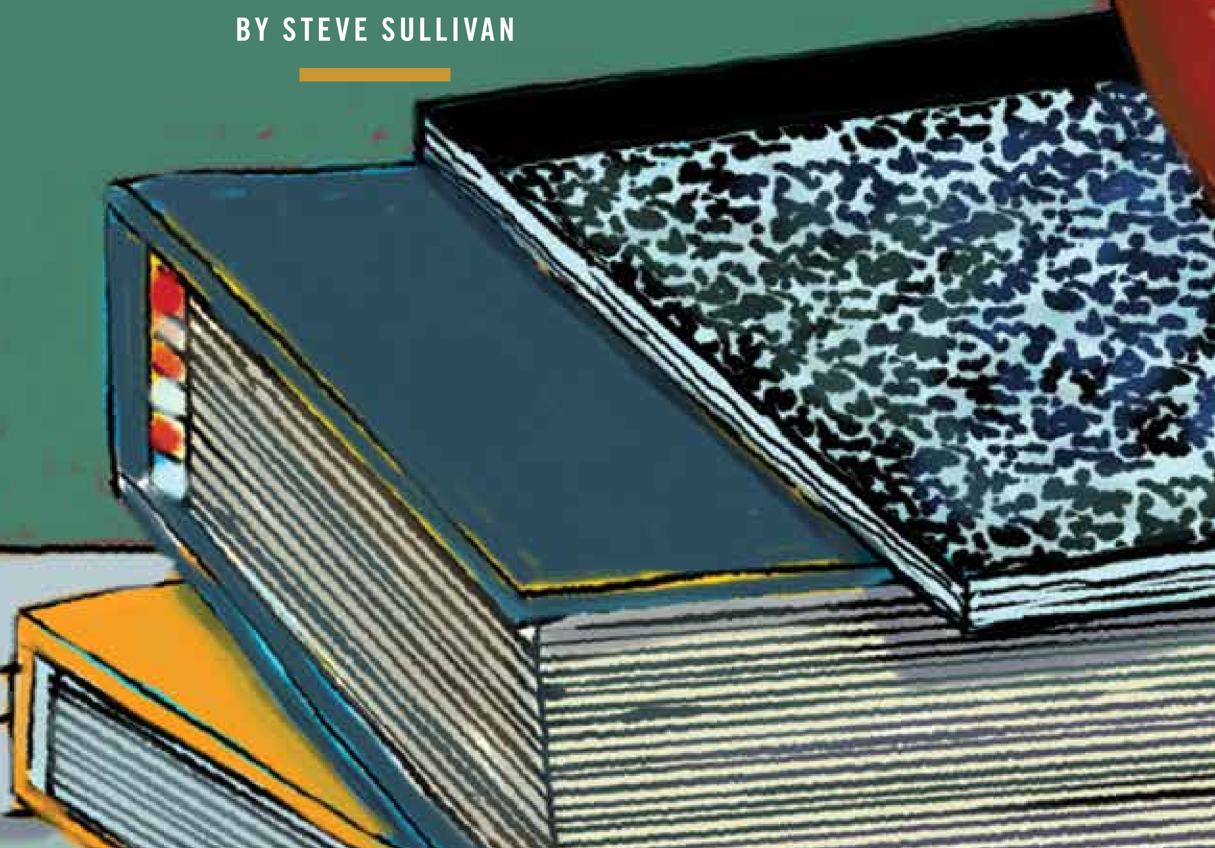
State teacher retirement systems all across the country are in trouble. Advisors need to understand what their states are doing to fix the problem.

The Pension Underfunding Threat

BY STEVE SULLIVAN



These days, the three-legged stool is something that's more likely to turn up on an episode of "Antiques Roadshow" than it is to serve as a metaphor for comfortable retirement.

Not one of its legs is without a wobble: Defined benefit pensions are pretty much history. Social Security will start experiencing shortfalls at about the same time the number of retiring Baby Boomers reaches its peak. And private savings in 403(b)s and 401(k)s are subject to the vagaries of markets and the economy. No wonder that a National Institute of Retirement Security (NIRS) study released earlier this year found that 85% of Americans — not just teachers and government employees — are worried about whether they'll be able to retire.

Teachers have always been particularly fortunate. The mainstay of their retirement has been a usually generous defined benefit state teachers' retirement system (STRS) that they supplemented with defined contribution plans such as 403(b) and 457 accounts and personal savings. Now, even those defined benefits, at least in their traditional form, may not be there for many future public school retirees.

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The reasons for this are varied and complicated. Since most STRS are DB plans, their funding is determined by complex actuarial formulas based on myriad facts and assumptions:

- How many people are in the system now?
- How many will there be next year, the year after that, and so on?
- Where will the money come from? How much will come from contributions? From investments?
- How will these investments perform?

That's a lot of uncertainty that has to be tamed by actuaries in order to provide a defined benefit.

Not surprisingly, recent economic downturns have taken a severe toll on all states' budgets, and not just their retirement plans. And even when times are good, states don't always fund their pension plans to recommended levels or take advantage of booms to build a financial cushion against the inevitable bust. After all, those obligations are long-term and usually way down the road. As long as states have enough money on hand to pay their current retirees, it's often tempting to use those funds that should be covering future retirees for something else more immediate and, perhaps, more politically attractive.

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Widening Gap

According to "Public Pension Pressure in the United States," a 2011 paper written by the Wharton School's Olivia S. Mitchell, "50 states together owed $117 billion to their pension plans in 2009 but in fact only contributed $73 billion. Contribution shortfalls of this nature have persisted because state DB plans follow rules set by their legislatures rather than by a centralized accounting authority; this permits politicians to adjust payment targets in times of fiscal stringency."

In 2012, the Pew Trust Center on the States updated a previous report, "The Widening Gap," that quantified the disconnect between what state pensions were promising and what their funding would allow them to provide. It reported the overall pension gap as $757 billion.

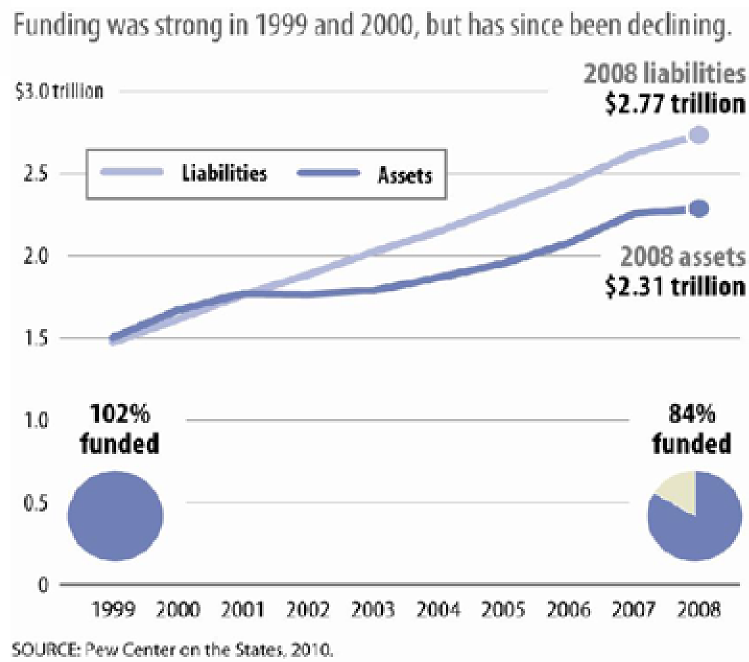
"States continue to lose ground in their efforts to cover the long-term costs of their employees' pensions and retiree health care," the report concluded, "due to continued investment losses from the financial crisis of 2008 and states' inability to set aside enough each year to adequately fund their retirement promises. States have responded with an unprecedented number of reforms that, with strong investment gains, may improve the funding situation they face going forward, but continued fiscal discipline and additional reforms will be needed to put states back on a firm footing."

The Pew report's scorecard (see Fig. 1) used the states' own actuarial assumptions — usually an 8% rate of return on investments — to evaluate their unfunded liability. Under those criteria, states such as North Carolina, South Dakota, Washington and Wisconsin were funded at 95% or better. Others at the bottom of the rankings were Connecticut, Illinois, Kentucky and Rhode Island, with funding below 55%. The majority of the states in between need improvement, the report concluded.

Many experts question, however, whether an 8% ROI is realistic in today's economic environment, preferring a more realistic 3.5% or 4% (see Fig. 2). But even a more moderate assumption of 6.25% can radically alter the results. New York, for instance, using an 8% assumption, projects a funding level of 101%, making it a star performer. Drop the assumption to 6.25%, however, and the Empire State is only 87% funded — better than most. But use the worst-case scenario and the ratio drops to 65%, putting it in the "needs improvement" territory.

The Pew report also assumes that a funding ratio of 80% represents a fiscally healthy plan. Not so fast, warns the American Academy of Actuaries. "A funded ratio of 80% should not be used as a criterion for identifying a plan as being either in good financial health or poor financial health," it said in an issue brief published last year. "No single level of funding should be

FIGURE 1: HOW DID WE GET HERE?



In 2000, nearly half the states were fully funded. In 2008, only four states could make that claim.

Source: The Pew Charitable Trust

FIGURE 2: RATE OF RETURN ASSUMPTIONS MATTER

State:	**New York**	Plans:	**ERS, PFRS**	
Return Assumption	**Assets**	**Liabilities**	**Percent Funded**	**Unfunded Liability**
8.00%	$148,861,000	$146,733,000	101.45%	-$2,128,000
6.25%	$148,861,000	$171,879,765	86.61%	$23,018,765
3.50%	$148,861,000	$229,732,022	64.80%	$80,871,022

State:	**Illinois**	Plans:	**SERS, SURS, TRS**	
Return Assumption	**Assets**	**Liabilities**	**Percent Funded**	**Unfunded Liability**
8.50%	$64,012,414	$117,391,324	54.53%	$53,378,910
6.25%	$64,012,414	$143,383,415	44.64%	$79,371,001
3.50%	$64,012,414	$191,644,211	33.40%	$127,631,797

Source: The Pew Charitable Trust

identified as a defining line between a 'healthy' and an 'unhealthy' pension plan. All plans should have the objective of accumulating assets equal to 100% of a relevant pension obligation, unless reasons for a different target have been clearly identified and the consequences of that target are well understood."

Accelerated Change

So what are states to do? They have options, but they're limited by a very important fact: Most state teacher pension systems are contracts, negotiated between school systems and teachers, usually through their unions, and ratified by state legislatures. "Once benefits are put in place, it's a contract and it's very difficult to work around it," says Dave Ellingson, research analyst at Trust Builders in Dallas, OR. "When there's an abrupt change in the situation — like the crash of 2008 — that does not negate a contract just because the STRS can't perform. The employer is on the hook for making up the shortfall."

So states and school systems can't just liquidate a troubled plan the way a private company can, leaving participants to be covered by the Pension Benefit Guaranty Corp. They have to either raise more money or cut benefits, and they have to do it by tinkering around the edges.

"Changes include reducing the percentage of crediting, trimming back early retirement ages so you're not able to retire at 55 with full benefits as you could before, and using more stringent actuarial valuations of the plan," says Edward Dressel, president of Trust Builders. Dressel's company creates software that helps advisors illustrate retirement benefits for more than 500 public pension plans across the country. He says that keeping up with the pace of change has created a couple of full-time jobs at his firm.

"When I bought the company in 2007 I could keep up with the changes pretty well," he says. "But because of what happened in 2008, I started seeing a lot of new changes coming in. In 2010 I hired a full-time person just to keep track of the changes and even he started falling behind. I hired another analyst in 2011. The volume of changes is overwhelming."

"State retirement systems across the country are making changes," concurs Ellie Lowder, TGPC, TSA Training and Consulting Services in Tucson, AZ. "Many of them are trying to move away from a defined benefit plan and substitute a defined contribution plan so the risk is on the employees rather than the employer." But even if they decide to do that, the contract won't allow the change to apply to participants already covered under the plan. They can apply only to new hires.

"Another option to reduce the unfunded liability is the cost-of-living adjustment (COLA)," says Ellingson, "which is usually controlled by the state legislatures. Most systems are tied to the consumer price index. So if you're a retired teacher with a $30,000 annual retirement benefit, let's say the COLA is 5%. Some systems grant a maximum of up to 3% but guarantee a minimum of 1%. That means retirees can depend on a COLA but it may not match the inflation rate in those years when it's high. But even in years when there is no inflation, they'll still get an increase of 1%."

No Easy Choices

However they deal with it, pension underfunding is an issue that states can no longer afford to ignore. But whatever they do usually ends up being politically unpopular and wildly controversial. In New York, Gov. Andrew Cuomo (D) has proposed a plan that would replace the traditional defined benefit plan for new employees with a defined contribution plan and reduce their benefits, bringing down the wrath of public employee unions.

According to the *Chicago Tribune*, Illinois' $96.8 billion STRS pension debt is the worst in the country. Gov. Pat Quinn's (D) plan to freeze the annual 3% cost of living increase for three years is drawing fire from politicians, unions and pensioners alike.

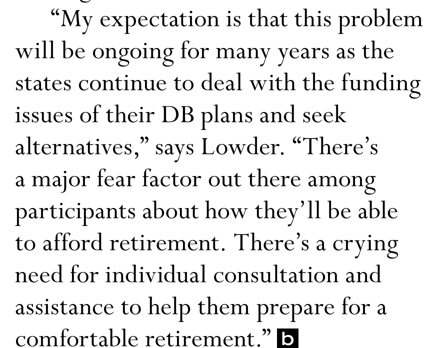
And in California, critics charge that Gov. Jerry Brown's (D) hard-fought pension reforms — increasing the retirement age for new employees, capping the annual payout at $132,120, eliminating numerous abuses of the system and requiring workers who aren't contributing half of their retirement costs to pay more — are too little, too late, and do nothing to solve the growing problem.

And similar controversies rage in other states that are trying to address the problem in their own ways.

Advisors Have a Role

Though 403(b) advisors can't do anything to solve the problems of underfunded STRS, they can and should understand how their systems work. Educating clients about what part of their retirement will be funded by their defined benefit pension (as well as Social Security and their voluntary contributions) is a big part of the service they provide. Vendors and providers can be good sources of this information, as well as the STRS themselves. Lowder suggests that advisors get a copy of the state system's employee benefits handbook and use it to gain a complete understanding of how the system works, including how to calculate a person's benefits.

Advisors should be aware, she adds, that if states shift from DB to DC plans for new employees, those state pension benefits will no longer be determined by the traditional actuarial formula, making them even harder to calculate.



"My expectation is that this problem will be ongoing for many years as the states continue to deal with the funding issues of their DB plans and seek alternatives," says Lowder. "There's a major fear factor out there among participants about how they'll be able to afford retirement. There's a crying need for individual consultation and assistance to help them prepare for a comfortable retirement." b

Steven Sullivan is a freelance writer in Baltimore, MD, and former editor of 403(b) Advisor.