Lessons from the Great Recession

How Actions Taken After the Great Recession Have Helped Prepare Public Pensions for Future Economic Downturns

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The Bad News

"Public Pensions Face Worse Funding Decline Since Great Recession," Bloomberg News, July 22, 2022

"The Next Financial Hammer to Fall: Public Pension Funds," The Hill, June 28, 2022

"Market Rout Sends State and City Pension Funds to Worst Year Since 2009," Wall Street Journal, August 9, 2022

"Are Government Pension Funds in Crisis Again?" LA Times, September 9, 2022

"If You Think US Pensions are Safe, Just Wait," Wall Street Journal, October 10, 2022

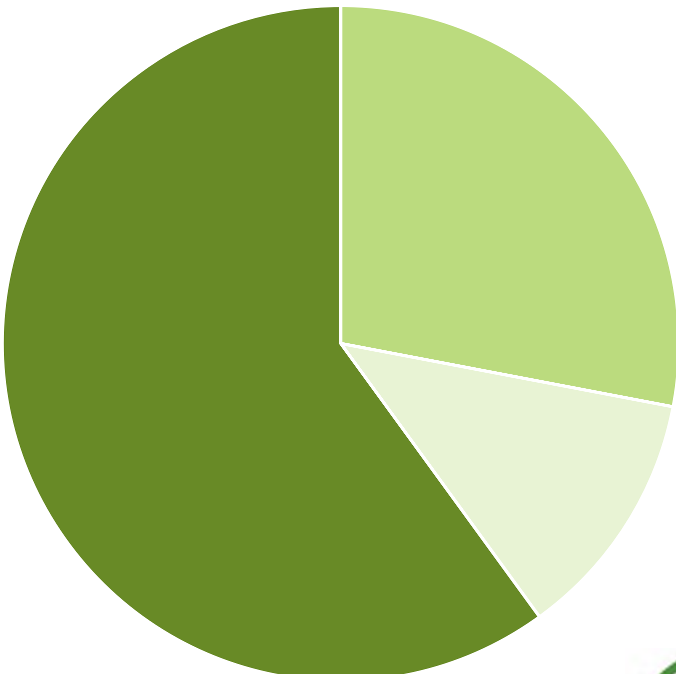
The Reality

- Many public pension plans adopted strategies in reaction to the Great Recession that have greatly improved the health of these plans, including:
  - Sharing the risk of investment losses with plan members.
  - Reducing plan benefits.
  - Increasing employer contributions and using premium tax revenues to reduce plan liabilities.
  - Having a more pessimistic outlook for future market returns.
  - Reviewing and changing plan assumptions so that they more accurately reflect experience.

The Reality

- After the Great Recession, a majority of public pension plans recovered their pre-recession asset levels within six years.
- In recent years, public plans have reported record-high asset levels.
- Higher than expected investment returns in the last two years have given many plans a sizeable cushion to help manage the impacts of lower investment returns in the future.

Defined Benefit Plan Sources of Revenue



Investment earnings: 60%

Employer contributions: 28%

Employee contributions: 12%

Source: "State and Local Spending on Public Pensions, FY18," *National Association of State Retirement Administrators*

Defined Benefit Funding Requirements

- Florida law requires that defined benefit pension plans be funded on a "sound actuarial basis."
- This means the annual contribution to each retirement plan be sufficient to pay the *full actuarial cost of plan (*100% funded).
- Employer is responsible for paying current pension costs ("normal cost") plus amortizing unfunded liabilities over period of not more than 30 years.
- Employer bears the risk of pension fund investment losses.

1. Sharing the Risk

- Many plans took steps to increase required employee contribution rates to help offset pension fund investment losses.
- Plans introduced variable Cost of Living Adjustment (COLAs) tied to investment return.
- Example of variable COLA:
  - Fixed COLA of 2% + Variable COLA in amount determined by Plan actuary but not more than 1% and only if the plan is “sufficiently funded.”
  - What does “sufficiently funded” mean?

Summary of Pension Costs

- Pension costs comprised of two components
  - Normal cost: Cost to pay all the future benefits due under the plan. This cost needs to be kept at a reasonable level to ensure pension costs are not out of control.
  - Unfunded liability: Past service costs that result from pension benefit changes or actuarial losses that occur when the plan's actual experience does not meet the actuarial assumptions.

2. Reducing the Normal Cost: FRS

- In 2011, Florida Legislature adopted a number of changes to FRS, including:
  - 3% member contribution (previously no member contribution)
  - Elimination of 3% COLA for service after 7/1/11
  - New normal retirement dates
    - Regular class – age 65 or 33 years of service (previously age 62 or 30 YOS)
    - Special risk – age 60 or 30 years of service (previously age 55 or 25 YOS)
  - As a result of the changes, employees paid more into the plan and retired later, which help reduce the overall cost of the plan.

Legal Challenges

- Florida courts have consistently upheld pension benefit changes so long as the changes are applied *prospectively*.
  - *Scott v. Williams*, 107 So. 3d 379 (Fla. 2013): Employee contribution and COLA changes "were prospective changes within the authority of the Legislature to make."
  - *City of Hollywood v. Bien*, 209 So. 3d 1 (4th DCA 2016): Termination of option to delay DROP participation was a prospective change consistent with *Scott*.
- Other Florida cases focused on obstacles to implementing benefit changes and will influence future pension reform efforts by local governments.

Then vs. Now

- In the event of another Great Recession, will benefit reform be the first line of defense?
- Many of the local governments that reduced pension benefits after the Great Recession restored and even increased benefits in recent years.
- Pension benefits play a key role in recruiting and retaining employees. Reduction in these benefits can have a negative impact on hiring efforts.
- Historic increases in the Consumer Price Index (CPI) may undermine efforts to reduce COLAs.
- Before considering any pension benefit change, local governments should obtain an actuarial analysis that includes long-term cost projections, performed by an independent actuary.

Premium Tax Money to Offset Pension Costs

- In 2015, Florida Legislature adopted changes to the use of premium tax money to help offset pension costs.
- Default rules (F.S. 185.35/175.131):
  - **Annual premium tax revenues** – excess above 2012 amount must be split 50/50:
    - 50% to offset city pension contribution
    - 50% to fund share plan
  - **Accumulated premium tax revenues** (have not been used to fund benefits; held in reserve in pension fund) – must be split 50/50:
    - 50% to pay down unfunded liability
    - 50% to fund share plan

Premium Tax Money to Offset Pension Costs

- Default rules on the use of premium tax revenues can be modified by mutual agreement of:
  - city and union,

    or if no union:
  - city and a majority of active plan members
- Plans with share plans in place as of 12/1/2000, and plans created by special act of the legislature, are deemed to be mutually agreed deviations.

3. Reducing the Unfunded Liability (UAL)

- As a result of investment losses in Great Recession, many plans experienced large increases in unfunded liabilities.
- Florida law permits a plan to amortize its unfunded liability over a period of *not more than* 30 years (see F.S. § 112.64).
- Employing shorter amortization periods creates the appearance that long term costs are rising, though existing costs are simply being paid down more quickly and *will lead to lower costs down the line*.
- Authority to reduce amortization period for local government plans is vested in the pension board.

Reducing the Unfunded Liabilities (UAL)

- To help pay down the UAL faster, many pension boards elected to reduce amortization period to 20 or 15 years. In some cases, the impact of these shortened amortization periods could be seen in the next few years.
- In addition, some local governments made policy decisions to make additional annual payments to strategically pay down their plan's unfunded liability.
- When the pension boards partnered with local governments, plans were able to dramatically reduce the UAL, which may help protect these plans from future losses in the event of another recession.

4. Reviewing Assumptions about the Plan

- Actuarial losses occur when a pension plan's actual experience does not meet the plan's actuarial assumptions.
- Actuarial losses increase the unfunded liability of a Plan and can occur even in years of strong investment gains.
- For local plans, pension board is responsible for setting plan assumptions in consultation with the plan actuary. Changes in assumptions can put upward pressure on employer contributions in the short term (which can hinder desire for benefit increases).

5. Changes in Investment Return Assumptions

- Since the Great Recession, many public pension plans have adopted more conservative investment return assumptions.
- Leading up to the time of the Great Recession, the average investment return assumption was 8%. Now, it is close to 7% (FRS is 6.8%).
- Like reductions to the UAL amortization schedule, lower investment return assumptions create the appearance that pension costs are rising (since employers have to make up the difference).
- However, lower investment return assumptions can lessen the risk of future losses, since the plan's actual experience is more likely to meet this expectation.

A Word on “Smoothing”

- Asset smoothing is the practice of recognizing investment gains and losses over a defined time period (for example, 5 years) to help reduce plan volatility (“actuarial camouflage”).
- Many public pension plans have had strong investment gains over the past 10 years, and as a result are better funded now than they were in 2007.
- For example, the average rate of return for Florida pension plans was 20% in 2021.
- Realizing this gain over a 5-year period will help offset any investment losses that occur in that time period.

Takeaway

While it may be tempting to believe that public pensions are facing an imminent threat of the next Great Recession, recent studies have shown that actions taken by state and local government pension plans after the Great Recession have helped strengthen and prepare these plans for future economic downturns.

Questions?

Sources

- Bond, T., Doonan, D., and Tauzer, T, "*Examining the Experience of Public Pension Plans Since the Great Recession*," National Institute on Retirement Security, October 2022.
- Brainard, K., "Public Pension Plan Investment Return Assumptions," National Association of State Retirement Administrators, March 2022.
- Brainard, K., "Overview of Public Pension Plan Amortization Policies," National Association of State Retirement Administrators, April 2022.