The Select Committee on Pension Policy

Pensions 101

Laura Harper and Lisa Won
Office of the State Actuary

May 13, 2008

Office of the State Actuary
"Securing tomorrow's pensions today."

What Are Pensions?

- Lifetime retirement payments
- Promises made today to pay benefits in the future

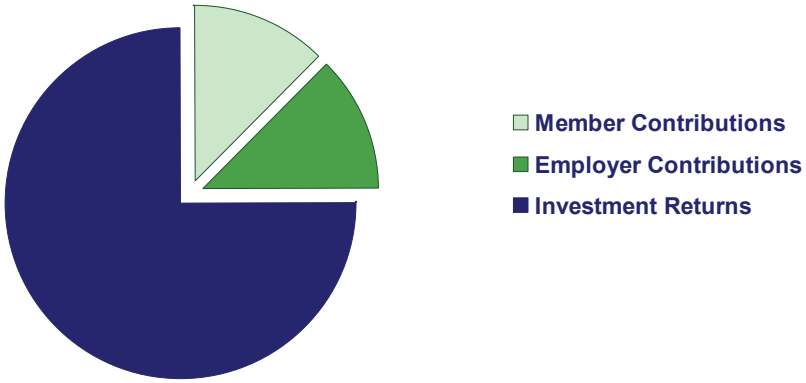
Securing The Promise

- How do you secure a promise for something that happens in the future?
- What are some challenges in securing that promise?

Who Pays For Pensions?

- In Washington, members and employers pay
  - Cost-sharing between them
- Contributions are pooled and held in a trust fund
- Fund grows through investing

Pension Trust Fund



Member Contributions

- Payroll deduction
- Impacts take-home pay
- Pre-tax

Employer Contributions

- Made at time of member contributions
- Taken out of government budgets
- Impacts taxpayers

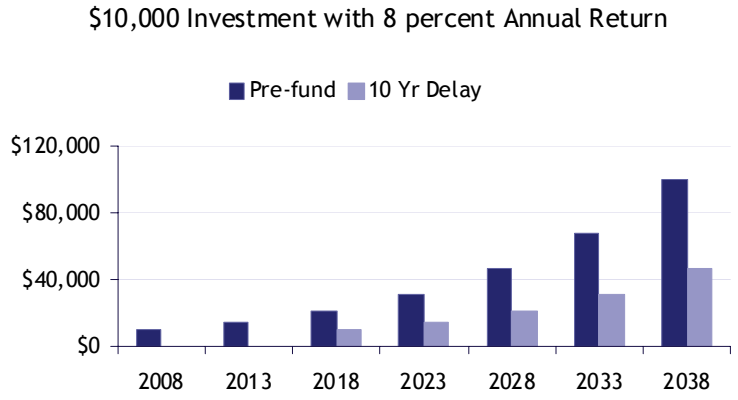
Investment Returns

- Contributions invested in trust
- Trust assets grow over time
- Investment returns provide about 75 percent of plan costs

Time Value Of Money

- A dollar is worth more today than a dollar in the future
  - Money has potential earning capacity
- Maximize growth by timing of contributions
- Pay now, or pay <u>more</u> later

Example Of Time-value Of Money



Possible Funding Approaches For Pensions

- Pay-as-you-go
- Up-front payment
- "Systematic actuarial funding"
  - Regular payments over time

Pay-As-You-Go

- Contributions made as benefits are paid
- Most expensive financing plan
  - Little to no investment earnings
  - Minimal use of time-value of money
- No investment risk

Up-Front Payment

- Single payment today for all future benefits
- Least expensive approach
  - Single lump sum grows with investment earnings
  - Original payment and investment returns offset future pensions
  - Maximum use of time-value of money
- Investment risk

Systematic Actuarial Funding

- Regular payments over time
- Investment returns earned systematically over time
  - Cost is in between pay-as-you-go and up-front payment plans
  - Still using time-value of money
- Investment risk is spread over time
- Washington uses this approach

How Does Systematic Actuarial Funding Work?

- Estimate future pension benefits
  - What will future benefits be?
  - When will they be paid?
- Estimate time value of money
  - What will future investment returns look like?
- Consider risk: will there be enough money in the future?

What Do Actuaries Do?

- Make assumptions about the future
  - Future pension benefits
  - Future investment returns
- Monitor risk
  - Annual valuations
  - Experience studies
- Apply professional judgment
  - Guided by standards of practice
  - Reasonable conservatism

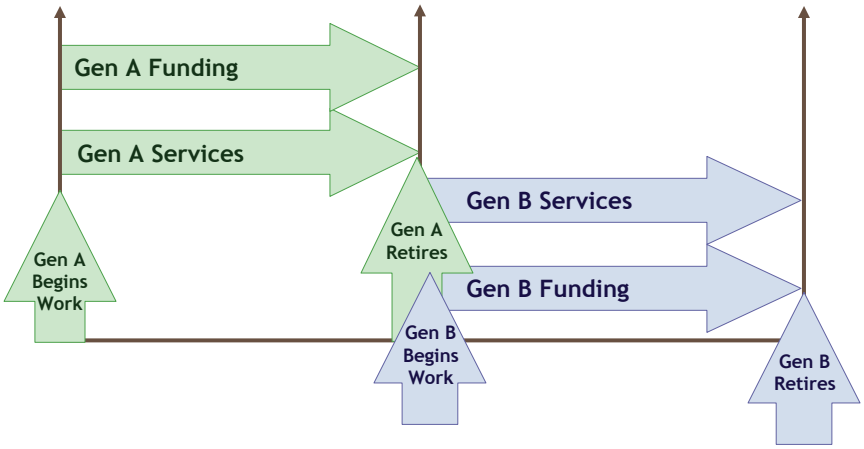
Actuaries Calculate The Regular Payments

- Regular payments are the contributions under systematic actuarial funding
  - Expressed as a percent of pay
- Actuaries consider
  - Future pension benefits
  - Value of assets in trust fund
  - Future service payroll

Fairness Across Generations

- Systematic actuarial funding looks to the future
  - Benefits are funded over members' working lifetimes
  - Flexibility comes with challenges around long-term fairness
- How do you assure fairness across generations?
  - Fund the plan so costs of members' benefits are paid by the taxpayers who received services from those members
  - This is called "intergenerational equity" (IE)

Example Of IE



IE And Funding Approaches

- Pay-as-you-go
  - Current generation pays for retired (past) generation
  - Like Social Security
- Up-front payment
  - Current generation pays for future generations
- Systematic actuarial funding
  - Current generation pays for pensions earned by current generation

A Long-Term View of Funding

- Actuarial funding occurs over a long period of time
  - Multiple generations
- Actuaries smooth trends out over time
  - Example: ups and downs of stock market
- The funding approach assures there is enough money to pay future benefits
  - Assumptions about the future are reasonably conservative

Will There Be Unfunded Liabilities?

- Regular payments fund future benefits over a long period of time
- The unpaid cost of benefits we expect members to earn in the future is called "unfunded liability"
  - Plans 2/3
  - This kind of unfunded liability is natural
- Fairness across generations is present

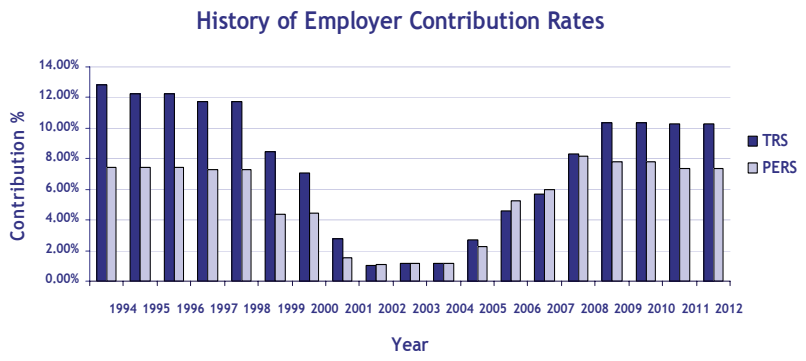
Is That The UAAL We Hear About?

- No, "unfunded actuarial accrued liability" (UAAL) is different
- PERS 1 and TRS 1 have UAAL
- What is UAAL?
  - Unpaid cost of benefits members have already earned ("accrued")
  - Money in plan not enough to pay them
- Fairness across generations is compromised
  - Current generation paying for past generation

Recap of Systematic Actuarial Funding

- Regular payments over time
- Fairness across generations
- Long-term view

Is Recent History Consistent?



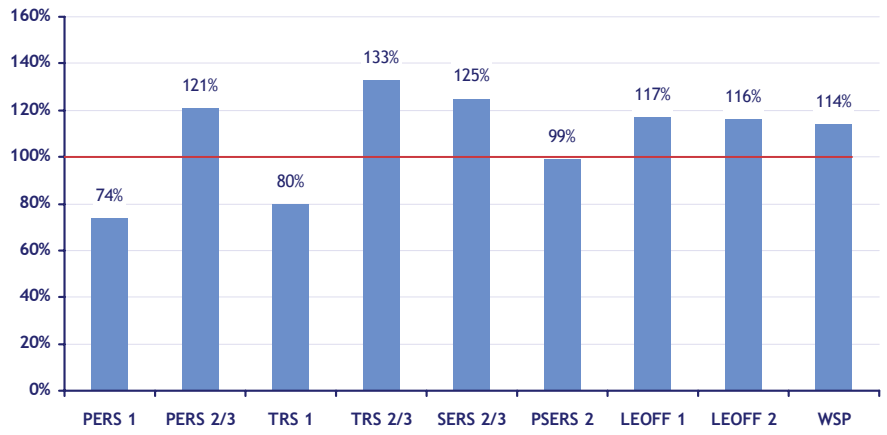
Impacts Of Rate Swings

- Painful as rates go back up
  - Affects member take-home pay (Plan 2)
  - Affects government budgets (taxpayers)
- Fairness across generations?
- Lost opportunity to invest contributions
  - Time value of money

How Are WA Plans Doing Today?

- Washington compares favorably to other public and private sector plans
- Combined funded status is 100 percent
  - Ratio of assets to earned benefits (accrued liabilities)
  - Includes all plans

Combined Funded Status Is 100%*



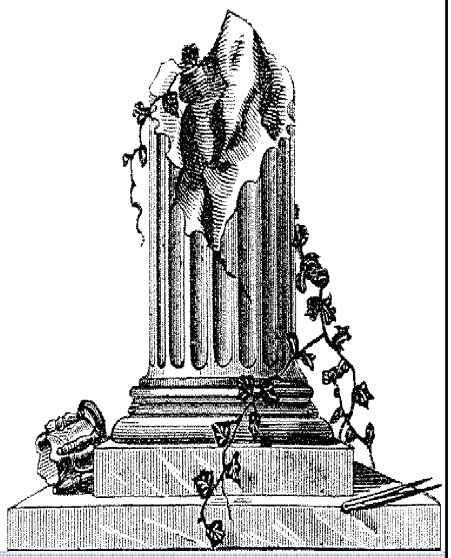
**As reported in the 2006 Actuarial Valuation Report (AVR).*

Two Plans Have UAAL

- PERS 1 and TRS 1 - Unfunded Actuarial Accrued Liabilities
  - Unpaid costs of past ("accrued") benefits
- Causes
  - Benefit increases for past service ("retroactive")
  - Underfunding
- Action plan in place to pay the UAAL
  - Fully fund Plans 1 by 2024
  - Requirement in statute

Lessons Learned From Plans 1

- Benefits were not sustainable
- Funding was not enough
- Plans closed to new members



Other Methods Help Secure Benefits

- Funding method for Plans 2/3
  - "Aggregate" funding method
  - Does not allow UAAL
- Minimum contribution rates
  - Regular payments cannot fall below set amounts
  - Provided in statute
- Asset smoothing
  - Helps reduce short-term swings in contribution rates

Recap

- What are pensions?
  - Lifetime retirement payments
  - Promises made today to pay benefits in the future
- In Washington, the promises are secured by systematic actuarial funding
  - Regular payments over time
  - Fairness across generations
  - Long-term view

Examples Of Future Challenges

- What happens to systematic funding when benefits increase?
  - Middle of generation
  - Past generation
- What happens when investment results change?
- What happens when contributions are delayed?
- What happens when payments for current costs are postponed?

How Can We Meet Future Challenges?

- Discipline
- Balance
- Fairness
- Eye toward sustainability

Are The Benefits Secure?

- Yes, but the future is still unknown
- When a change is proposed, what is the impact on the long-term security of the promise?

Evaluating Changes To System

- Are we systematically contributing the dollars needed to make investments work for us?
- Will the change allow us to keep fairness across the generations?
- Will the pension plan be sustainable over the long-term?

Questions?

Opportunities To Learn More

Select Committee on Pension Policy (SCPP)

www.leg.wa.gov/scpp

See the 2008 Orientation Manual found under "Publications"

Office of the State Actuary (OSA)

http://osa.leg.wa.gov/

Department of Retirement Systems (DRS)

www.drs.wa.gov