Four Practical Steps on the Path to Financial Sustainability in Public Pensions

United States state pension plans are underfunded by an estimated $2.2 trillion, though reported estimates vary.[1] And soon, these unfunded liabilities will be under greater scrutiny. Beginning in 2015, 100 percent of states will be required to show unfunded pension liabilities on their balance sheets.

Given the high stakes, it may seem a high mountain for public sector leaders in the US and Europe to climb to shape an affordable, balanced plan to get pension plans on a path to fiscal recovery. But by taking this journey, leaders will assure the bond markets—and the public—that government is fulfilling its mission of managing pension funds responsibly.

Pursuing the path to progress

The annual required contribution (ARC) helps to measure the extent to which plan sponsors are meeting their financial obligations. In 2012, employer contributions equaled 80 percent of the required payments.[2] The one consistent factor for states with large unfunded liabilities is a history of providing payments at less than the ARC over a sustained period of time. If states with unfunded pension plans were able to fully fund their pension plan ARC for the next decade, the pension gap would be largely closed.

It's making this journey that can create unmanageable pressures on state budgets. However, recent initiatives show that public leaders with foresight can pursue the path to financial sustainability. These pragmatic, practical steps can enable a transformation that delivers lasting effects.

Step 1. Pilot new plan designs for diverse employees of the future

Forty percent of public employees are set to retire in the next 10 years. Leaders can take advantage of this demographic shift, coupling it with new technologies and business processes to reshape their HR pyramid, thereby lowering long-term personnel and benefit costs.

Options that states are pursuing include capping the salary on which public pensions are figured and raising the retirement age. For example, Illinois raised its retirement age to 67, the highest of any state, and several European Union countries have increased the early retirement age for civil servants. Other measures include linking Cost of Living Adjustment (COLA) increases to threshold rates of return for investment portfolios and alternative early retirement options. States such as Hawaii have increased their vesting period from five to 10 years and many states are changing the final average salary calculation period from three years to five years.

Step 2. Pursue innovative investment strategies

As the recession eases, increased returns should help close the pension gap. Some states are using analytics to be more insight-driven and improve management of their investment portfolio. According to the Accenture North America Pensions Survey[3], public retirement agency leaders are using analytics to analyze portfolio performance statistics (69 percent), risk in portfolio (69 percent), performance of various portfolio components (66 percent) and comparative portfolio components (62 percent).

The public sector could adapt practices used in the private sector to reduce unfunded liabilities. For example, Ford and GM used financing tools to offload a portion of retirement obligation. GM cut one-fifth of its global pension liability when it shifted management of white-collar pension plans for 118,000 salaried retirees. Both GM and Ford have taken steps to reduce risk by closing off their plans to new participants, offering lump-sum buyouts and shifting to more conservative investments.[4] A number of states, like Michigan and Rhode Island have provided alternative 401(k)-style plans as a choice for retirees.[5] Working creatively and taking cues from the private sector will help agencies to move toward public entrepreneurship.

Pension Gaps: The Cost of Inaction

With a pension-funding ratio falling at least 21 percent over the past five years and a shortfall topping $100 million, Illinois' debt was rated by credit agencies at the lowest level among US states. Even though Illinois was rated only one level lower than California, the interest rates it was forced to pay on its bonds was five times the yield of similar California debt issues. After five unsuccessful attempts by the Governor and the legislature, a pension compromise was passed in December 2013. Illinois estimated that the cuts in its bond ratings over a single year of inaction cost taxpayers $180 million in additional interest costs.

Source: "Illinois Breaking Pension Impasse saves 29% on Debt: Muni Credit", Bloomberg News, December 12, 2013.

Step 3. Assure that pension payments are prioritized in operating budgets

States sometimes use a binding revenue and expense forecast methodology. This means that all parties agree on revenue and expense targets, and will not vary from them in the legislative process—which is viewed as a financial best practice by credit rating agencies.

Applying this practice to pension payments over a concrete term would provide assurance to bond markets, participants and stakeholders that the state is addressing its long-term liabilities as a priority. For example, a state can allocate a specific recurring revenue source specifically for payment on unfunded pension liabilities, keeping these payments out of contention with other operating budget priorities. In Kansas, lawmakers have directed that 80 percent of proceeds from excess real estate property sales will be used to pay down unfunded pension liability.[6]

France is making pension payments a priority by initiating a trust fund to secure government pension plans, separated from the general budget.[7]

Step 4. Build administrative savings by using back-office mergers and analytics to sustain benefits

Administrative mergers are helping public sector entities to control administrative costs through centralized administration. The Florida Retirement System (FRS), which covers all state government, county, school district and most municipal employees, has been merged since the 1970s. The system is seamless from an employee point of view as it centrally manages assets and investments, while administering retirement benefits and issuing pension checks centrally.[8] Most retirement benefits to public employees in Indiana are administered through the Indiana Public Retirement System, which was created when legislators merged the Indiana Public Employees Retirement Fund and the Indiana Teachers' Retirement Fund.[9]

Investing in the future

By taking pragmatic steps to solve the financial sustainability challenge, leaders can slowly—but surely—climb the mountain and get to firm financial footing. Beneath their feet, they will have spending on past generations, and arrayed before them will be the right paths to support future generations. From this clear vantage point they can take the right action to solve this important public policy issue.

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