After the Fact | States of Innovation—Securing Public Pensions

Originally aired Jan. 29, 2021

Total runtime: 00:19:30

TRANSCRIPT

Marcie Frost, chief executive officer, California Public Employees' Retirement System (CalPERS): The first part of our mission is serving our members. They could be police officers. They can be school employees. And what we do is we make sure they have a retirement benefit at the time that they're ready to stop actively working. CalPERS, over the last four years, has been making very difficult decisions about the appropriate funding of these pension plans.

Dan LeDuc, host: For the Pew Charitable Trusts, I'm Dan LeDuc, and this is "After the Fact."

That was Marcie Frost. She leads the California Public Employees' Retirement System. CalPERS is the nation's largest public pension system with a global investment portfolio of around $420 billion—that's a figure larger than the GDP of countries like Norway or Singapore.

And the difficult decisions Marcie mentions affect the retirement benefits for nearly 2 million public employees, retirees, and their families. It's a challenge facing many states across the country, as they look at the best ways to fund their public pension systems.

And that's something Greg Mennis works on at Pew, helping states develop solutions to close the funding gap between what state pension plans owe to their public employees and the money that's being put aside to pay that bill. A Pew analysis in 2018 found that that funding gap in the states totaled $1.24 trillion—that's with a "T." And that's the data point for our episode. It's a number experts see growing, with the impact of the coronavirus pandemic.

Amid those daunting numbers, states like Pennsylvania and California have discovered innovative ways to ensure pensions systems keep their promises to retirees.

Music break

Greg Mennis, director, public sector retirement systems, The Pew Charitable Trusts: I think most people are familiar with 401(k) plans. And over 60 million Americans save through retirement primarily through those kind of plans. In the public sector it's different, where most of the state and local workers participate in what are called defined benefit pension plans. By and large, this distinction, where in the public sector benefits are paid for through a fixed payment in retirement, and the money is managed by the state. And today there's about $4 trillion in public assets invested in stocks, bonds, and alternative investments, is the main difference between how most people save for retirement.

Dan LeDuc: All of us have to be concerned about our retirement. All of us need to plan ahead. Why should all of us care about the public employee pension system?

Greg Mennis: A well-funded pension system in the public sector can literally cost billions of dollars less every year from the state or local budget as compared to one that's severely underfunded. The short answer is that in a well-funded system, the state or local government is setting aside money each and every year while people are working to pay for their benefits when they retire.

And as it turns out, by doing that, it ends up that compounded investment earnings end up paying for the majority of the benefit. In contrast, a severely underfunded system, where the money hasn't been set aside while people are in their working years, they lose out on all kinds of compounded investment earnings. And as a result, the majority of the cost comes out of the state or local budget. Just to provide some examples, we look at pension plans and states like Tennessee and South Dakota and Wisconsin, all of which are close to being fully funded.

Dan LeDuc: It sounds like if states are planning their investments properly and in a smart way, the earnings made by those investments can pay for the costs to maintain the fund. What happens with states that aren't fully funded?

Greg Mennis: If you look at states like Kentucky, Illinois, New Jersey, all of which have less than 50% of the assets set aside, that budgetary cost is closer to 15% of revenue on average. So that means in those states, somewhere between 1 in 10 and 1 in 5 tax dollars is going to pensions. That adds up to about $10 billion of additional cost across those three states alone.

And so I think this is important from the public's perspective, not only because of the impact it can have on state and local budgets, and in turn the resources that are available for public services, but also because having a well-funded system helps to prevent reductions in workforce or cuts in benefits that you need to attract a skilled public workforce.

Dan LeDuc: To be very specific, that means there's less money to buy police cars or pave roads or any other public service that taxpayer dollars fund. I mean, and that's a big deal. Government is always looking to contain costs, whether it's health care or other issues. This is a big-ticket item for a lot of states.

Greg Mennis: That's absolutely right. And as I mentioned before, I think for a larger state and city, the difference between having a well-funded system and an underfunded system comes out to billions of dollars every year. So, everything from investments in education and infrastructure to health care ends up being strained in the budget each and every year.

Dan LeDuc: It almost sounds like innovation is old-school ideas of just figuring out what the bills are going to be and make sure you got the money to pay for them.

Greg Mennis: I think that that's right. And there are two ways in particular where I think innovation plays a role. First off, it has to do with how plans and pension systems plan for uncertainty. And in some of the states that I just mentioned, Tennessee, Wisconsin, and South Dakota, they have very clear predefined rules about how to adjust costs if there's a downturn, or if investments underperform. This includes building a margin of safety into assumptions, essentially setting aside a rainy day fund within the pension system, and then also adjustments to worker benefits that are clearly understood by everybody. And, so, from that perspective, I think innovation goes back to looking at the policies and practices that these states have been following for decades.

Dan LeDuc: Of course, a lot of the places getting attention now are the places that are troubled. The last number I saw was something like $1, almost $1.3 trillion in a shortfall between what's going to be owed workers and what's available. That's a mind-boggling number. Is it possible to catch up?

Greg Mennis: I think it definitely is. Certainly, it's the case where the underfunded systems that have fallen behind on contributions and now have less of the assets on hand, it's a problem that's been decades in the making. And it's going to take decades to address that.

I think Pennsylvania is a great example of a state that came out of the first decade of the 2000s with severe financial strain on their pension system. But over the course of almost a decade, it's incrementally taken steps toward reform to make their system more stable while preserving a path to retirement security for their public workforce.

Dan LeDuc: Let's talk a little bit more about Pennsylvania. How did they figure out the problem? And how did they start figuring out the fixes?

Greg Mennis: Sure, so I think the case study in Pennsylvania actually goes back to around the year 2000 when the system was actually reporting having more than 100% of the assets to pay for future benefits. And, in fact, around that time, the average state pension system was just about fully funded. Pennsylvania passed a law to increase worker benefits when the system was flush by as much as 25%. And then over the first 10 years of the 2000s, made less than 50% of the annual required contributions that the actuaries were recommending. That ranked Pennsylvania 49 out of 50 states with only New Jersey behind them in that core measure of fiscal discipline. And in addition to that, of course, the 2000s were not a bull run in the stock market. We saw the dot.com downturn in 2001 and 2002, as well as the financial market crisis in 2008 and 2009. So, as the result, they went from being overfunded to having less than 50% of the assets on hand to pay for benefits.

Dan LeDuc: Can you walk us through the stages of reform that Pennsylvania went through?

Greg Mennis: First off, beginning in 2012, the state endeavored on a plan to dramatically increase annual contributions phasing it into a $5 billion increase each and every year out of the budget from $1 [billion] to $6 billion. Then in 2017, they passed what I think we consider a landmark reform that strengthened that commitment to pension financing in the category of innovation, implemented a well-designed hybrid plan. One with a smaller pension benefit combined with a 401(k)-style savings account.

A result that I think would help the state manage risk better in the future but also provides a more equitable source of retirement savings across the workforce, including those that may change jobs. And the last piece, as part of that reform, was the requirement to more carefully examine two things. No. 1, reducing investment fees. And the state has now completed a study and is expected to save $3 billion on that front, but, second, to explore the use of pension stress testing. And this, I think, is an area where we've definitely seen more recent innovation. That stress test requirement was passed just this November in Pennsylvania. But, actually, it's the kind of analysis that the state used in 2017 to assess the risk of the system and come up with an estimate of savings between $5 [billion] and $30 billion for that reform.

Dan LeDuc: Let's stop for a minute now and let's make sure people understand what a stress test is. I mean, I'm old enough to have been to the cardiologist recently. I know what I have to do there. How does that fly here?

Greg Mennis: Stress testing is a simulation technique that public pension plans can use to evaluate how they're going to weather an economic downturn by running "what if" scenarios.

I think the science of this is very technical and can be fascinating. But it's really the art of the exercise and establishing the stress test report that can be understood by government plan sponsors and decision-makers

There are now 12 states that have a mandatory requirement in law to regularly publish a stress test report that is designed specifically to educate policymakers on the budget impacts under different economic circumstances.

Dan LeDuc: Obviously, the pandemic has been playing a big role in state budgets. We've seen revenues cut over the last six months for a lot of states. What's that going to mean for addressing the public pension system?

Greg Mennis: Well, first off, I think it's important to first acknowledge the critical role of state and local governments are playing in managing the national public health emergency.

From a budget and pension perspective, the way that we've been thinking about it is, it's important to have a plan both for next year, managing a very difficult budget year with a lot of uncertainty around the pandemic, but also connecting that to a longer term strategy that will require some resetting expectations. And we've been thinking about this overall as a five-year planning process, both through the downturn from COVID-19, as well as the expected recovery.

Dan LeDuc: The more I talk to you, this is important, interesting stuff. I mean, billions of dollars, public services that could or could not be funded based on these decisions, the future retirement security of literally millions of Americans, and the fact that things can change so dramatically. You mentioned just within a decade you can go from being fully funded to 50% funded because decisions change that fast.

Greg Mennis: It's really a critical issue both for the performance of state and local governments. And at the same time, it's part of a conversation about retirement security for all Americans, which is another significant challenge that the country's having.

Music break

Dan LeDuc: A big conversation is occurring in the nation's biggest state—California. Here's Marcie Frost, who you heard at the beginning of this episode.

Marcie Frost: So, CalPERS is the California Public Employees Retirement System. And it is a system that takes care of both retirement and health care for about 2 million public-sector workers in the state of California. So, those public-sector workers could be firefighters. They could be police officers. They can be school employees and state employees. And what we do is we make sure that they have a retirement benefit at the time that they're ready to stop actively working. And our portfolio sits at roughly $425 [billion] to $430 billion. That's 75% funded. So, if we were fully funded, that number would be much higher.

Dan LeDuc: At the state level, what are the pressures on people like you to try to make sure your fund is adequately funded? Right? I mean, there's an obligation that the state has made the state employees to get them a safe retirement. It helps you recruit good people and helps you keep good people. So, what are the pressures that you have to navigate to try to increase your numbers?

Marcie Frost: The biggest pressure that we have is as a pension plan is really the portfolio. And the expected growth on that portfolio year after year is 7%. And that is 7% after all fees are paid. That's 7% after you have adjusted for risk. That is certainly a pressure for the investment office, for CalPERS generally—the CalPERS board—and, essentially, every stakeholder who operates around us.

I think the second pressure is one that we've identified in our top three risks to the system, which is the employer—the 3,000 participating employers in CalPERS—their ongoing ability to pay the contributions, both on the unfunded liability side as well as the normal cost of the plan.

Dan LeDuc: How do you innovate to make sure that the funding is going to be there for the people who need it?

Marcie Frost: I think part of innovation is courage—having courage to make the tough decisions that really no one wants to have to make. You know, when I think about what's been innovative at CalPERS, I can really just reflect back on the last four years since I've been here. And one of the things we noticed right away is that the rate in which we invest—and that we assume that we're going to make 7.5% on the money that's being provided by the members and the public employers. When we looked at the markets, we did not see that as being feasible.

So, we knew that we had to work with our stakeholders, work with our legislators to help them to understand the problem we were trying to solve. That if we were not able to get 7.5% earnings on the money, what that means is that our public employers would have to, by contributions, make up the difference between what we were able to earn and what we were expected to earn.

When we don't hit the expected rate of return, for the most part, the public employers are paying for those costs. There is a dollar amount associated to it. And then it gets financed, if you will, over a 30-year period of time. It's almost like a home mortgage, where you're financing a certain debt. You purchased a home for $300,000. You finance that over 30 years. And you're paying $2,000 a month. That same principle applies to the unfunded liability. What we found in that financing of 30 years is that we had negative amortization, meaning that the contributions were not coming in a way that could even pay the interest associated with it. Remember, they're paying us 7% on that unfunded liability, because if that money was actually in the trust fund, the expectation is that it would be earning 7%. So, we have to make that up. And we're making that up through interest applied to that debt.

And we decided that that 30-year amortization was just not a financial policy that our actuaries could support, or frankly, the CalPERS organization itself could support. It certainly wasn't a fun message to have to send out to the members, and to our employers, and all of our stakeholder groups. But it ended up, effectively, being the right decision to make.

Dan LeDuc: And California also adopted its version of stress testing that Greg Mennis explained earlier.

Marcie Frost: California, at least CalPERS, has been stress testing, if you will, for quite some time. And, essentially, what that means is that we have these assumptions that we use in funding the system. But you need to stress test your assumptions. Stress test what happens if the markets don't return you 7%.

We load all of the valuation data in for that particular employer. And we put it back in their hands. They can run scenarios about what would happen. So, really stressing the assumptions that are used to fund the system under multiple scenarios, I think, is both about transparency, and it's about building trust in the system, and making sure that the decision-makers around you understand that you're thinking beyond the best-case scenario.

Dan LeDuc: What you've just described shows just the incredible complexity and number of factors involved. A lot of it sounds innovative because it seems like basic, smart way to do stuff—like sharing information, getting the people who are going to get pensions involved, too, because they're contributing to that. How hard was it for you to get some of those reforms in place, and get things closer to on track?

Marcie Frost: The outcome everyone wants is a healthy, sustainable pension plan. Because even though city managers, even those individuals in the municipalities or within the state departments themselves, they will receive a pension from CalPERS as well. So, there is this common goal about making CalPERS as healthy as possible. I think what was lacking a bit was some transparency about the challenges, and some transparency about how we were operating the portfolio or how we were operating the business.

Dan LeDuc: What is the one thing you wished maybe just the general public and taxpayers of California better understood about the importance of getting this right?

Marcie Frost: As people age, you don't want them running out of money. You also want them to have income. Because I think it's almost 90% of our retirees—$26 billion being spent in the state of California. So, this portfolio that's earning 7%, or earned 4.7% last year, is really this economic engine of paying these benefits at $0.60 on every dollar that then gets returned back to the communities in California where it's spent. And, so, I think, sometimes that is lost.

Music fades in

Dan LeDuc: Well, Marcie Frost, thanks so much. You've put in a lot of work in the last four years there.

Marcie Frost: We have. It's been a real team effort. Our work isn't done. We have challenges ahead of us. But we've made good progress.

Dan LeDuc: Thanks so much for the time today.

Marcie Frost: Yeah. Thank you.

Dan LeDuc: So, we're wrapping up our season on States of Innovation—whether it's making sure public pensions are funded, or communities are prepared for flooding, or ensuring treatment to meet the opioid epidemic is available, or any of the other topics we've covered this season, you can learn more at pewtrusts.org/afterthefact.

All of these innovations are based on facts and research, which provide a common ground for policymakers to come together and find solutions to problems. At a time when many may lament gridlock in government, they're examples that show progress is possible and that things can be made better.

We'll continue that theme the next time you hear from us. The nation's civil legal system has been undergoing big changes over the last few decades, and those changes have only been exacerbated by the pandemic.

Erika Rickard, project director, civil legal system modernization, The Pew Charitable Trusts: Chief Justice [Bridget Mary] McCormack, the chief of the Michigan Supreme Court, says, "This was not the disruption that we wanted, but it was the disruption that we needed."

Thanks for listening. For the Pew Charitable Trusts, I'm Dan LeDuc and this is "After the Fact."