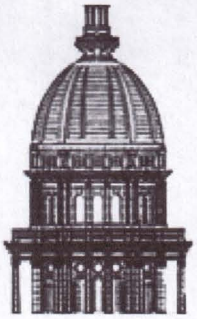

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The Shortfalls of Oklahoma's Defined Benefit Public Pension Plans

by *Cory Eucalitto* | February 19, 2014

Across the country, unfunded public pension liabilities are the single largest threat to the stability and solvency of state and municipal governments. State Budget Solutions' research in "Promises Made, Promises Broken - The Betrayal of Pensioners and Taxpayers," found that state-administered pension plans have a combined $4.1 trillion unfunded liability.

The figure may seem distant or abstract. The truth, though, is that these unfunded liabilities amount to trillions of dollars worth of shattered promises.

What happened in Prichard, Alabama illustrates the devastating impact of broken pension promises. There, hundreds of people spent their entire adult lives in public service. The pay was never exorbitant and the work never glamorous, but, in exchange for a career spent serving the community, the city promised its employees a secure retirement benefit.

Prichard's retirees depended on their defined benefit pension checks but, in 2009, the checks stopped coming. It was not just one or two missed checks. Retirees went many months without their pension payments. When they did finally resume, they were for far less than the benefit amount thought by many to be legally guaranteed. The amount of the pension benefit to retirees had been slashed in the city's bankruptcy proceedings.

Retirees and employees were the innocent victims of Prichard's failure to keep its promise of a secure retirement to those who had sacrificed so much to serve their community.

The Prichard retirees' tragic story serves as an important a wake up call for both public employees and the country's state and local governments alike. It is part of a broad and compelling case for reforming Oklahoma's government's defined benefit pension systems, and instead providing employees a defined contribution alternative.

Broken Promises of Retirement Security

Discount rates

The single largest priority of state and local retirement systems must always be ensuring public employee retirement security. By this metric, how is Oklahoma doing today?

According to 2013 valuations, the state's six active defined benefit plans, plus the Wildlife Conservation Retirement Plan which was recently closed to new members, carry an $11.4 billion unfunded liability. They have a combined funded ratio of 66.5 percent. According to the Oklahoma Council of Public Affairs, this unfunded liability exceeds the state-appropriated budget by 52 percent.

The problem, however, may be worse than official reports show. In fact, a more accurate accounting shows that Oklahoma's public pension systems have a $43.7 billion unfunded liability. The reason lies in the assumptions, particularly the discount rate, used by public defined benefit pension plans across the country.

Actuarial Versus Market Valued Funding
(figures in thousands)

Plan	Actuarial Unfunded Liability	Market Valued Unfunded Liability
OPERS	$1,577,249	$9,071,008
Teachers	$8,112,100	$27,295,071
Police	$228,600	$2,095,181
Fire	$1,270,247	$3,969,484
Law	$165,431	$945,411
Judges	$6,878	$229,699
Wildlife	$23,465	$101,982
Total	**$11,383,970**	**$43,707,836**

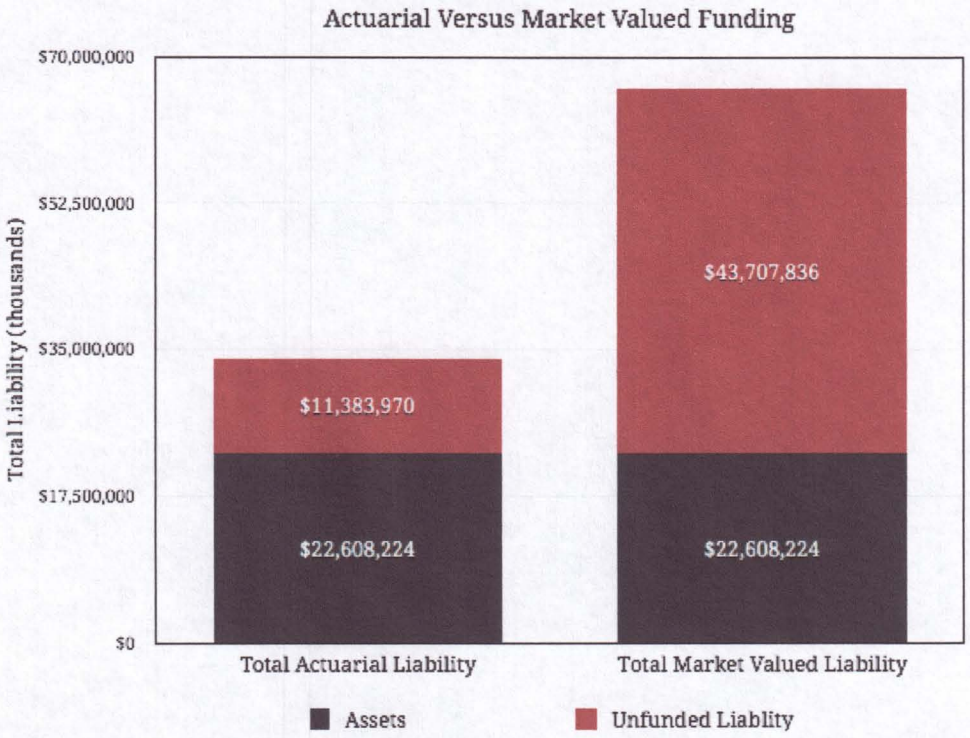
Funding a pension system requires determining how much money needs to be set aside today in order to pay benefits many years in the future. To do this, plans must "discount" their liabilities. That is, they begin with an estimate of benefits owed in the future and subtract annual interest at certain discount rate.

Oklahoma's plans, like most, currently use a rate in the range of 7.0-8.0 percent, based on their assumed investment return. But this practice does not account for the legally guaranteed nature of public pension benefits. Economist Andrew Biggs explained in his paper "Understanding the Argument for Market Valuation of Pension Liabilities":

> *"Economists argue that the discount rate used to value future pension liabilities should reflect the fact that pension benefits are guaranteed, even if the returns on a pension's investments are not. More formally, the*

discount rate applied to the liability should be based on the risk of the liability, not the risk of any assets used to fund that liability."

The 15-year Treasury yield is one possible risk-free rate. As of February 11, 2014, that rate was 3.085 percent. By this measurement, the state's combined funded ratio falls to just 34 percent. It's unfunded liability skyrockets to $43.7 billion.



Unfortunately, many policymakers prefer to discount plan liabilities at the higher assumed investment return rate for one simple reason: it makes liabilities appear smaller, and thus requires fewer resources to be set aside today, despite the fact that this practice, as Biggs points out, gives "fully-funded" plans "only a roughly 50-50 chance of generating returns sufficient to pay full benefits."

Skipped contributions

The use of economically unsound discount rates is not the only way that the status quo shortchanges public employees. The betrayal is often far more direct, like when states fail to make their actuarially determined annual required contribution (ARC). A sponsor's ARC is determined in part based on the discount rates discussed above. It is the amount that actuaries determine must be set aside today to ensure future funding.

Often driven by short-term budget pressures, policymakers across the country have made a habit of shortchanging their state's ARC. Oklahoma is no different. In the last 10 years, Oklahoma has skipped nearly $3 billion worth of contributions into its state pension systems. The skipped $3 billion itself not only has to be made up in the future, but also the lost 7-8 percent in anticipated earnings. These skipped contributions lead to underfunding even in cases where a plan consistently earns its assumed investment returns.

Required Versus Actual Contributions
Fiscal Years 2004-2013
(figures in thousands)

Plan	Required Contributions	Actual Contributions
OPERS	$3,146,529	$2,150,817
Teachers	$6,445,543	$5,633,708
Police	$944,243	$530,883
Fire	$1,434,920	$841,419
Law	$373,986	$233,113
Judges	$66,492	$26,074
Wildlife	$34,069	$34,680
Total	**$12,445,782**	**$9,450,694**

Flawed assumptions and the tendency of policymakers to succumb to short-term budget pressures by skipping out on parts of the ARC are two of the ways that the structure of defined benefit pension plans undercut the promise of retirement security. Unfortunately, poorly funded pension systems also have a negative impact on taxpayers and local communities.

Endangering Communities

Whatever the cause of unfunded DB pension underfunding, it increases the cost of maintaining the pension system. The reason is simple: facing unfunded liabilities, a state or municipality must pay both the cost of retirement promises incurred over the course of the year and an additional "amortization" cost that is expected to help the plan increase its funded status over a period of time.

Take the Oklahoma Teachers Retirement System, for example. The plan's total 2013 ARC was $620 million. Of that, only $116 million funded the "normal cost" required to pay for newly earned retirement promises. The remaining $504 million was required just to pay off the plan's existing unfunded liability.

Plan underfunding has played a part in pushing Oklahoma's total ARC from $957 million in 2004 to nearly $1.2 billion in 2013. The state's ARC peaked in 2011 at $1.6 billion.

In any given year, these costs ultimately crowd out funding for other state budget priorities. Each dollar spent reducing a plan's unfunded liability is a dollar not spent on education, healthcare, police and fire services, and other services on which people depend. To make matters worse, as the costs of servicing unfunded liabilities grow, the added budget stress only increases the pressure on policymakers to further sacrifice pension funding.

Keeping Politics Out of Retirement Security

Fortunately, there is a solution to pension underfunding that allows Oklahoma to keep its promises to current employees and retirees, protect taxpayers and communities, and ensure long-term fiscal health. It involves closing the state's defined benefit pension systems to new members and instead instituting a defined contribution (DC) alternative.

The Oklahoma Council of Public Affairs recently outlined the basics of just such a plan in "Saving Workers' Retirement: A Comprehensive Plan to Save Oklahoma's Retirement Systems." A DC plan would give new employees a secure retirement. They would receive a percentage of pay into a private retirement account. In the private sector, the average employer contribution is 5.7 percent. Under OCPA's recommended plan, employees with four years of service would receive as much as 7 percent of their salary. With professional investment advice, these accounts would grow over the course an employee's entire professional career.

Of course, meaningful pension reform must also focus on eliminating the state's already built up unfunded liabilities. Under OCPA's recommendation, the difference in employer contributions (currently 16.5 percent for OPERS, minus the new 7 percent contribution) would be paid into the DB plan to help pay down the unfunded liability. Keeping existing employees in the old DB plan would similarly help eliminate the possibility of transition costs. There is no way around the fact that eliminating unfunded liabilities will take both time and resources. Placing new employees in a DC plan, however, ensures that unfunded liabilities do not grow in the future. OCPA's independent actuarial study of these reforms for both OPERS and TRS found that "such a plan would have no transition costs, would not increase liability of the system, and would allow the state to fully pay off the liability of all the systems over time based on the recent asset return of the system."

DC plans offer many benefits to employees. Unlike the current DB setup, employees would have complete ownership over their own retirement. Their retirement account would be portable across jobs, in both the public and private sector. And in the event that the state attempted to skip out on its end of the deal, employees would know immediately and have the power to hold their employer accountable. When it comes to retirement security, DC plans truly remove politics from the equation. Similar plans have proven effective in the private sector and for most higher education faculty across the country. It is time that Oklahoma's state government caught up.

Oklahoma's billions in unfunded pension liabilities pose a dire threat to both employee retirement security and funding for vital state and local services. The unsound structure of public defined benefit plans pushes governments across the country to sacrifice long-term fiscal health for short-term gain. Placing new employees in a defined contribution plan would ensure that Oklahoma is able to keep those promises already made to its public servants, while simultaneously providing retirement security to a new generation of workers.

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