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Public Pensions Adopt Cost Sharing Mechanisms to Stem Volatility.

- **Maine and South Dakota pensions tweak cost of living increases**
- **About a third of states have funds sharing risk with workers**

In spring 2016, Sandy Matheson, the executive director of the Maine Public Employees Retirement System, was panicking.

After earning 2 percent the previous fiscal year, record low bond yields and global stock market turmoil were dragging the pension's returns even lower — and further away from its 6.9 percent assumed annual return.

She modeled government pension payments under a scenario where investments returned 4 percent a year for four years and then 6.9 percent thereafter. The result: government contributions would increase every year until 2032, reaching 21 percent of payroll from 10 percent.

"My hair was on fire," Matheson said. "[I was] near hysterical at the thought of what's going to happen if we continue on earning less than our discount rate. We'd just be cutting benefits."

Risk Sharing

Matheson, with the help of the fund's actuarial firm, Cheiron, put together a plan in which the risks of investment gains and losses weren't just assumed by taxpayers, but shared between local governments, their employees and retirees. Maine adopted the risk-sharing plan for municipal employees that participate in the system starting the fiscal year than began July 1. Matheson plans to brief lawmakers on extending it to state employees and teachers.

"The goal of the model is to prevent any kind of damage or harm to the plan, due to the volatility in the markets," Matheson said. "Employer rates have always gone up and down with the market but both employee and employer rates will now go up and down. They'll share in market risk."

Most U.S. public pensions were fully funded as recently as 2000, but the collapse of the internet bubble and the Great Recession caused by the financial crisis of 2008 — combined in some cases with years of contribution shortfalls and unfunded benefit increases — resulted in pension debt exceeding $1 trillion. Between 2003 and 2013 the cost of making required pension payments almost doubled, according to a 2017 report from the Pew Charitable Trusts.

In response, some pensions have adopted formal cost-sharing mechanisms, adjusting contributions or benefits, instead of making unplanned benefit cuts or contribution increases. Almost 30 defined benefit pension plans in 17 states use cost-sharing mechanisms to manage risk, according to the Pew report.

Some states, such as Illinois and New York, have constitutional or statutory prohibitions on changing retiree benefits.

Capped Rates

Maine capped contribution rates by municipalities at 12.5 percent and 9 percent for employees, giving both parties certainty about how high costs would go to make up for investment losses. If pension losses exceed the capped contribution rates, retiree cost of living adjustments are reduced. Maine's local governments and employees share in investment gains and losses at a 55 percent to 45 percent split.

Had Maine's plan been in effect after the financial crisis, contribution rates would have increased to 12.5 percent and 9 percent and held there for five years. Retirees would have had a 30 percent annual reduction in cost of living adjustment for seven years, according to Gene Kalwarski, chief executive officer at Cheiron, a McLean, Virginia-based actuarial and financial consultancy.

"Under a traditional plan, you have one lever that deals with something like a recession, that's the employer contribution," Kalwarski said. "Here we've got the COLAs as well as the member contributions that reduce what otherwise would have been an employer contribution spike."

When the markets rebound and investment gains exceed the assumed investment return, the COLA would increase until reaching a cap of 2.5 percent. Further gains would allow employers and employees to reduce contributions for services performed by current members when the plan is fully-funded, to a minimum of about 14 percent, 7.7 percent for employers and 6.2 percent for employees.

That would have served the pension well in the 1990s when roaring stock market gains allowed governments to stop making annual contributions, Kalwarski said.

Cost Adjustment

In South Dakota, where employer and employee pension contributions are each fixed in law at six percent of pay, the state adopted a plan that changes cost of living adjustments depending on the funding status of the pension, said Rob Wylie, executive director of the South Dakota Retirement System.

"We were looking for ways to have the plan move with the marketplace, reward the plan when times were good, but also contract the plan when times were not so good," Wylie said. In most other public pensions "the benefits aren't the flex point, the contributions are."

South Dakota's pension is 100 percent funded. If the funding level falls below 100 percent, the cost of living adjustments can be moved between 0.5 percent and 3.5 percent depending on the plan's funded status and inflation. If the ratio of the pension's assets to liabilities falls below 80 percent, certain ancillary benefits must be cut, in addition to the cost of living adjustments.

While beneficiaries know their cost of living adjustments may vary depending on the market, their defined benefit payment is secure, Wylie said. Before the pension adopted its new structure in 2016, South Dakota's actuary estimated that cost of living adjustments represented 25 percent of its total liability.

"A defined benefit puts all the risk on the employer and defined contribution puts all the risk on the member," said Kalwarski. "Why put it on one side completely? Those shouldn't be your only choices."

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