



# PERSPECTIVES

## Pension Reform - A “Top-Down” Roadmap to Success

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For most public sector retirement systems, their funded statuses have declined and their contribution requirements have increased over the past decade. These trends have prompted various levels of pension reform across the country. Given our first-hand experience with some of the most comprehensive pension reforms, we are commonly asked about the process that led to specific successful outcomes. Interestingly, what we find is that most successful reform processes tend to follow the same general path, whether it was intentional or not.

The reform process of a retirement system is essentially the same as any other problem-solving exercise. Most general problem-solving strategies will follow these basic concepts:

- Identify and acknowledge the problem
- Define the goal
- Brainstorm and test solutions
- Select the strategy
- Implement the strategy
- Monitor progress

Sounds a lot like “the Scientific Method” that our middle school science teachers drummed into our heads!

However, the complicating factor in pension reform is that there are numerous stakeholders with various objectives, so clearly defining the “goal” is complicated. In the public sector, there is rarely one decision maker. A governing body generally has decision making authority with each member of the governing body having their own unique perspectives and specific

metrics they are focused on. In addition, the metrics used in the brainstorming and strategy selection are based on a series of complex assumptions, which may or may not bear out in the actual future.

Thus, we prefer to follow a similar strategy as used in general problem solving, but modified to be more useful for a pension reform process. A “top-down” approach that first determines an overall structure and magnitude of change, including the development of a contribution strategy, and then details the specific design modifications to achieve those objectives has proven to be very effective.

The alternative, and unfortunately more common, approach would be to start at the level of the individual provision changes and work toward an ultimate solution. This approach can create a set of benefit provisions that: 1) are overly complex; 2) may not meet the goals of the stakeholders; 3) may be based on negotiating power instead of sustainable solutions; 4) may take months, if not years, to develop; and 5) are very costly to model and implement. This approach can lead to analyses performed for various benefit proposals which are not materially different than each other.

For example, one consideration may be the cost difference between a two-year deferral on the cost-of-living adjustment (COLA) after retirement versus a three-year deferral. While this type of decision is important, it should be addressed after a general consensus has been reached about the overall magnitude of required change and the desired contribution strategy. The difference between the two provisions, in this example, may likely



be measured in the millions of dollars, when the ultimate changes may need to be measured in the tens, if not hundreds of millions of dollars.

After the overall magnitude of the necessary change has been agreed upon, finalizing the details of how to get there can come more quickly, resulting in a less costly process. Also, the detailed provisions can be created with a more strategic mindset for the members to receive appropriate and dependable benefits while the plan sponsor can still attract the types of employees it wants to retain and have those members, as well as current members, retiring in a predictable pattern.

By taking this “top-down” approach, the process will have a higher probability of meeting more objectives of more stakeholders, which are likely to include some combination of the following:

1. Have a high probability of being a lasting, long-term solution;
2. Be based on a sustainable contribution policy;
3. Provide an appropriate amount of retirement income at reasonable retirement ages;
4. Meet the human capital goals of the plan sponsor;
5. Protect all stakeholders against the most unmanageable fringe risks;
6. Optimize efficiency to minimize the amount of contributions needed to provide the benefits while balancing risks across generations;
7. Have increased disclosure on the level of funding risk; and
8. Have a feasible and agreeable transition plan.

## Leadership

Pension reform can be a brutal process. Stakeholders will fight for the interests of themselves and their constituents (as they should). Looking back at successful pension reforms with a truly realistic potential for a lasting, long-term solution, there is universally an individual (or a very small group of individuals) - typically an elected official - that is willing to “take ownership” and carry the responsibility of seeing the reform through.

They are willing to listen to the needs and demands of all parties; provide education to build consensus around acknowledgment of the problem; ensure the solution is comprehensive; and oversee the communication and implementation of the solution.

## Steps of a “Top-Down” Pension Reform Process

The following sections describe in more detail the identifiable steps of a “top-down” pension reform process.

### Step 1: Acknowledge That There Is a Problem and Clearly Define It

This step is critical. While it is unlikely there will be agreement on the optimal solutions, it is important for all stakeholders to have a clear understanding of the facts pertaining to the current situation. This does not necessarily mean strictly making a case for benefit cuts. There are several situations where the main source of risk is in a contribution policy that is inappropriate. Providing a common understanding of the current pension situation and how the situation was created is critical to ignite a lively and informed debate among all stakeholders. In addition, attaining a comprehensive understanding of potential limitations, such as contractual rights or tax base caps, will eliminate some possible solutions from consideration.

In the midst of this process, it is easy to forget that there are current and future plan members that rely on the retirement system for benefits in retirement. As a result, it is also important to be mindful of the current level of benefits provided by the retirement system and what the most appropriate level of benefits should be going forward.

Prior to the commencement of any reform process, it is prudent to have a full examination of the actuarial assumptions that will be used in the analysis. This will ensure the most up-to-date information is being utilized and help to strengthen the probability that a potential



change in assumptions shortly after the reform will not undermine the solution. If a full experience study has been performed in the last few years before the reform, it may not be necessary to revisit all of the assumptions. However, the macroeconomic assumptions should be fully evaluated, especially the overall long-term assumed annual rate of return.

In this step, it is beneficial for the actuary to create a few sample packages that meet the objectives. These are not recommendations, but rather sample illustrations of the magnitude of change necessary to achieve sustainability. To clearly illustrate the reforms necessary to meet the objectives, it is helpful to create: 1) a package that primarily solves the problem using additional contributions; 2) a package that primarily incorporates benefit modifications; and 3) a package that utilizes both. As discussed in Step 2, having an understanding of the necessary magnitude allows for a much faster decision making process and unworkable solutions can be immediately eliminated.

#### QUESTIONS DECISION MAKERS AND OTHER STAKEHOLDERS SHOULD BE ANSWERING IN STEP 1:

- ✓ What is the current situation?
- ✓ Are the current assumptions the best estimate of future experience and appropriate for decision making?
- ✓ What are the key actuarial metrics (i.e., unfunded liability, funding period, negative amortization, etc.) and which metrics will be the focus during the reform process?

## Step 2: Determine Necessary Magnitude and Velocity of Change

This step will attempt to match a sustainable contribution policy with an appropriate magnitude of changes to the benefit provisions. In addition, this step will begin the

process of attempting to determine the optimal long-term structure of the retirement system, including defined benefit, defined contribution or hybrid features, and how quickly (or the “velocity”) plan members should be transitioned to the new provisions.

An important step in a “top-down” process will be to identify what the plan sponsor can “afford.” If the plan sponsor can afford an increase in contributions, then the magnitude of the benefit changes can be relatively minor and an elaborate “reform” process may be unnecessary. Alternatively, if the plan sponsor can only afford another 5% increase in contributions and the identified magnitude of change needs to be closer to 20%, the magnitude of the changes must be much larger and more groups of members will need to be impacted.

For example, a possible solution to a sustainable contribution policy might be to decrease the value of the benefits for non-vested members and new hires by 30%, the value of the benefits for vested members by 20%, and the value of the benefits for current retirees and members eligible to retire by 10%. By starting with “a relative value of change” approach, decision makers should be able to form a consensus on the framework of the changes much sooner without getting bogged down on the impact of individual provision changes.

At the end of this step, all groups will have a general idea of how much change is needed and what the resulting contribution policy may resemble. This includes tentatively settling on a decision about whether and how to revise the retirement system’s current amortization policy.

Starting with a clean slate, this step can also involve modeling alternative benefit designs and plan structures. For future hires, the plan sponsor can maximize its use of the retirement program for human capital attraction, retention, and transition and the members can have a solid expectation of what their retirement program will be. The program can also be designed to manage the fringe risks for all stakeholders, while not piling risks onto groups of stakeholders who may have limited ability to manage those risks. The implications of various strategies can be discussed and ultimately a consensus may be



developed for a brief list of alternatives to “stress test” under various scenarios.

This is also when a discussion of potential risk-sharing provisions should begin. Dynamic modeling and years of actual experience with risk-sharing provisions in real time are continually proving that the most likely sustainable programs have some form of risk-sharing or contingent benefit provisions. It is more equitable and balanced to have smaller, well-conceived adjustments occurring more regularly than a large, political reform process in the middle of a crisis.

#### QUESTIONS DECISION MAKERS AND OTHER STAKEHOLDERS SHOULD BE ANSWERING IN STEP 2:

- ✓ What is the goal of the reform?
- ✓ What does the ideal program look like?
- ✓ How much of the changes should be shouldered by each of the different stakeholders (i.e., retirees, current active members, future active members, or taxpayers)?
- ✓ What steps can be taken now to reduce the possibility that plan reform will have to be revisited again down the road?

### Step 3: Model Strategies Based on Outcomes from Steps 1 and 2

The results from Steps 1 and 2 can be used to strategically develop combinations of changes which create alternatives of the appropriate magnitude for a short list of contribution strategies. By the end of this step, there should be a consensus on the contribution strategy, a narrow list of various long-term structures, and a very short list of combinations of benefit provisions. Another important aspect of this step will be to begin identifying transition issues between the current plan, the proposed

plan changes for current members, and the longer-term structure of the plan.

#### QUESTIONS DECISION MAKERS AND OTHER STAKEHOLDERS SHOULD BE ANSWERING IN STEP 3:

- ✓ What strategies achieve the goals?
- ✓ How long will it take to transition from the current plan to the new plan and what are the complexities?

### Step 4: Evaluate Solutions Using Stress Testing

To improve the sustainability of the ultimate solution, the actuaries should apply “stress tests” to the most favored scenarios. The purpose of this step is to: 1) learn where the stressors to the retirement system are; and 2) optimize policies and procedures (i.e., assumptions, funding procedures and methods, and perhaps even benefits) in order to improve sustainability and educate stakeholders of those potential stressors or risks. The focus is not on the outcomes of the test, but rather on the decisions that should be considered, or improvements to the processes, based on the outcomes of the test.

If the previous steps have been successful, there should only be a few potential combinations, and perhaps only one. The stress test should include various adverse outcomes mainly focused on investment returns being different than assumed, but other potential sources of risk should also be examined (i.e., population growth or decline). For the investment return testing, scenarios should include moderate underperformance over medium to longer timeframes as well as significant underperformance over shorter timeframes (i.e., “shock” events). Further, this testing should include an analysis of the expected year-to-year change in the contribution requirements.

The stress test should also allow for a full development of an appropriate strategy of transitioning from the current



plan to the long-term structure. If the long-term structure is the current program, then the transition issues will be minor. However, if the long-term structure is a hybrid defined benefit (DB)/defined contribution (DC) approach in a separate trust from the current plan, the transition issues will likely be significant.

**QUESTIONS DECISION MAKERS AND OTHER STAKEHOLDERS SHOULD BE ANSWERING IN STEP 4:**

- ✓ What are the potential sources of risk that could make the reform unsuccessful?
- ✓ How will the new provisions and funding expectations react to adverse experience?

## Step 5: Refine and Select a Strategy

At this point, it is not uncommon for there to be significant negotiations related to very specific elements of the proposed reform package. Based on the results of the stress testing, or more fact finding, there may be unintended consequences or new priorities. A full impact statement including projections should be developed by the actuary with full disclosure and explanations of all proposed changes, including the potential risks borne out in the previous stress testing.

**QUESTIONS DECISION MAKERS AND OTHER STAKEHOLDERS SHOULD BE ANSWERING IN STEP 5:**

- ✓ Do you have a full understanding of the actuarial impact of the proposed reforms and does the final strategy meet the initial goals?
- ✓ How does each strategy impact each of the different stakeholders and how does this compare to the initial goals?
- ✓ Which strategies are the most successful at reducing the possibility that plan reform will have to be revisited again down the road?

## Step 6: Implement the Strategies

This step is rather self-explanatory since any new policies will have to be incorporated into the communications and administrative systems of a retirement system. Legislation may also need to be drafted, promulgated and successfully passed.

## Conclusion

While pension redesign projects will always be a multi-faceted and time-consuming effort, it can lead to successful outcomes in the eyes of all stakeholders if a proven, organized, and well-thought-out process is followed. GRS and the systems it serves have accomplished long-term success with a “top-down” approach that first determines the overall magnitude of change needed in the redesign effort and then works through the necessary steps in this proven and effective process. By employing a more comprehensive problem-solving structure, true reform efforts have produced highly probable and workable outcomes giving stakeholders the requisite confidence that a long-term and sustainable solution has been achieved.





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## About GRS

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