Trends in State Retirement Systems

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Systems are battling back utilizing new plan structures, alternative investments, and corporate activism to improve their fiscal positions. The recent recession and current demographic trends have had a serious impact on state-administered public employee retirement systems. This article will present information about the current condition of state-administered public employee retirement systems, the problems they face, and the solutions they are employing.

Introduction

State-administered public employee retirement systems are among the largest institutional investors in the world. There are currently 218 state systems in the United States with a total 21.2 million active and inactive members. They command a total of $1.8 trillion in retirement assets, making them major players in the financial markets.

Public employee retirement systems were founded as a means of social welfare, similar to Social Security, to provide public servants with sufficient retirement income. The recent recession and current demographic trends have had a serious impact on state systems. With systems seeing an erosion of their financial position, many are looking at alternative investments and increasing their role in corporate governance to help them return to a fiscal stability that will enable them to meet future obligations.

This article will present information about the current condition of state-administered public employee retirement systems, the problems they face and the solutions they are employing.

Overview

The number of state-defined benefit public employee retirement systems (218) has shown modest growth recently. Over the past decade, the number of state administered public employee retirement systems has grown by 28 from the 190 in fiscal year 1993. These new systems usually extended state retirement benefits to new classes of employees, such as local law enforcement personnel, legislators or judges.

Membership in a state-administered public employee retirement system is not limited to state employees; in fact, local governments employ more than two-thirds of the active employees covered by state systems. In 2003, local government employees were 69.5 percent, or 8.7 million, of the total 12.5 million state system active members.

State system assets totaled $1.8 trillion in fiscal year 2003, or just over 83.2 percent of the total $2.2 trillion held by all public employee retirement systems that year. These assets were distributed across several asset classes, but more than three-fifths were concentrated in corporate stocks or other securities:

- Corporate stocks were worth $665.6 billion (36.9 percent)
- Other securities, which include investments held in trust by other agencies, mutual funds, foreign and international securities, conditional sales contracts, and other securities classifications totaled $442.6 billion (24.6 percent)

The remaining $694.5 billion in assets (38.5 percent) were distributed across a variety of other investments including corporate bonds, federal government securities, mortgages, real estate holdings and savings deposits.

System Size

State-administered public employee retirement systems are very large organizations. Ninety of the 218 systems had membership greater than 25,000 in 2003. The six largest systems individually had membership greater than the population of Wyoming (507,000) and the combined membership of the 10 largest (7,800,000) exceeds the population of Virginia (7,500,000).[1] The 10 largest systems and their memberships were:

- California Public Employees Retirement System (CalPERS) (1,480 thousand)
- Texas Teachers Retirement System (1,080 thousand)
- New York Public Employees Pension and Retirement System (964 thousand)
- Florida State Management Services Retirement System (892 thousand)
- Ohio Public Employees Retirement System (797 thousand)
- California Teachers Retirement System (CalSTRS) (720 thousand)
- Virginia Employees Retirement System (505 thousand)
- Wisconsin Employees Retirement System (487 thousand)

Table A
Percent Distribution of Assets in State Public Employee Retirement Systems: Fiscal Years 1997, 2002 and 2003

Asset Class	*2003*	*2002*	*1997*
Corporate stocks	36.9%	36.9%	34.8%
Total other securities (a)	24.6	21.8	20.3
Corporate bonds	14.4	16.3	15.2
Federal governmental securities	10.1	10.2	18
Cash and short-term investments	4.4	5.1	4.7
Mortgages held directly	1.2	1.1	1
Total other investments (b)	8.5	8.6	6.1

Key:

(a) Total Other Securities includes: investments held in trust by other agencies, securities of state and local governments, foreign and international securities, shares held in mutual funds, conditional sales, contracts, direct loans, loans to members, etc.

(b) Total Other Investments includes: real property, venture capital, partnerships, real estate investment trusts, and leverage buy-outs.

- North Carolina Teachers and State Employees Retirement System (469 thousand)
- Michigan Public School Employees Retirement System (468 thousand)

In addition to their large membership, state systems administer an enormous wealth of funds. An annual compilation of retirement fund data by *Pensions & Investments* magazine shows state-administered public employee retirement systems hold 7 of the top 15 spots in the world when ranked in terms of total retirement asset holdings. The top six in membership cited above hold more retirement assets than major corporations such as GE, IBM, Boeing, Verizon, Ford, AT&T or Daimler Chrysler.[2]

Membership and assets are concentrated in the largest systems. The largest 21 of the 218 systems accounted for 56.4 percent of total membership of all state systems in fiscal year 2003. These same systems also control 58.1 percent or $1,047.7 billion of the total $1,802.7 billion state retirement system assets.

The concentration of such large asset holdings in these top systems has made them very important players in the corporate world. Over the last several years, many systems have shown an increasing interest in influencing the direction of corporate boards.

Membership

State-administered public employee retirement systems had 21.2 million members in 2003, a 3.1 percent increase from 2002. Total membership has grown by 6.0 million or 39.5 percent over the past decade, while active membership increased 2.3 million (22.6 percent) and inactive membership increased 1.8 million (127.2 percent) over that period. Of the current 21.2 million members, 12.5 million are active members, 5.4 million are current beneficiaries, and 3.3 million are inactive members. Active members are employees who currently contribute to the system while inactive members are former employees or employees on military or other extended leave who retain retirement credits in the system.

Receipts

State-administered public employee retirement systems are funded in three ways:

- Current active members of systems (employees) pay contributions.
- Governments (employers) also make contributions
- Fiduciaries invest the system assets and earn returns on investment.

Total receipts for fiscal year 2003 were $130.0 billion. Earnings on investment constituted 52.5 percent ($68.2 billion) of total receipts, government contributions made up 28.5 percent ($37.0 billion), and employee contributions the remaining 19.1 percent ($24.8 billion).

Fiscal year 2003 did see a turnaround on investment earnings, which were $68.2 billion compared with the prior fiscal year's net loss of $63.5 billion. Even so, the 2003 figure was far less than the pre-recession levels that routinely averaged in the hundreds of billions of dollars.

Employee and government contributions both increased in fiscal year 2003. Employee contributions grew 7.7 percent from $23.0 billion to $24.8 billion. Government contributions grew by a much larger margin, from $32.0 billion to $37.0 billion, or just over 15.4 percent, in the same period.

Payments and Other Outlays

Total state retirement expenditures, or outlays, for 2003 were $109.0 billion, an 11.1 percent increase from 2002 ($98.2 billion). There are three types of outlays: benefit payments, withdrawals, and administrative and miscellaneous payments.

The largest outlay, benefit payments, totaled $98.8 billion for fiscal year 2003, an 11.4 percent increase from the 2002 level ($88.7 billion). Benefit payments made up 90.6 percent of total outlays for the year. Withdrawals accounted for 3.9 percent of outlays, totaling $4.2 billion, and increased 29.6 percent from the prior year ($3.3 billion). Administrative and miscellaneous expenses constituted the remaining 5.5

percent of total outlays, totaling $6.0 billion, a decrease of 3.6 percent from 2002 ($6.3 billion).

Beneficiaries and Monthly Benefit Payments

There were a total 5.4 million beneficiaries of state-administered public employee retirement systems in fiscal year 2003. This is an increase of 4.6 percent over the prior year. Of those, 85.6 percent (4.6 million) were retired on account of age or service, 6.3 percent (342,000) were retired on account of a disability, and 8.0 percent (436,000) were survivors of deceased former active members. These numbers increased by 4.3 percent, 6.5 percent, and 7.3 percent respectively from the prior year.

Monthly benefit payments averaged $1,449 for 2003, an increase of 5.5 percent from the previous year. These payments varied widely across the country. Retirement systems in Connecticut averaged the highest ($2,112), followed by Wisconsin ($2,075) and Colorado ($2,055), while systems in Iowa ($846), Indiana ($827), and Kansas ($822) had the lowest. Many factors influence these numbers including cost of living, inflation, and the composition and number of beneficiaries. Average benefit payments have consistently exceeded inflation rates over the past decade putting increasing pressure on systems.

The ratio of annuitants to active members increased to 43.2 percent in 2003 from 41.8 percent in 2002. This number likely will continue growing as the baby boomers begin to retire. The increase of the annuitant-to-active-member ratio has far-reaching implications on funding.

Receipts Compared with Payments

Systems must increase their funding reserves each year to cover future liabilities. These liabilities grow along with membership and inflation, so systems work to ensure a net inflow of funds to meet their future financial commitments.

Receipts exceeded payments in fiscal year 2003 by $20.9 billion. This is in contrast to 2002 when funds showed a net outflow of $106.7 billion. Although the net outflow in fiscal year 2002 damaged the financial position of the systems, several prior years showed very large net inflows of funds averaging in the hundred billions of dollars. This is not to say that the large net outflow in 2002 was not significant: it was, however, it is important to remember that retirement system fiduciaries and actuaries plan for the cyclical nature of the business cycle and have built assumptions into their plans to buffer against it.

Investments and Assets

Total asset holdings of state-administered public employee retirement systems for fiscal year 2003 were $1,803 billion, up from $1,775 billion in 2002. These assets were distributed across several classes, as seen in Table A.

The distribution of assets in 2003 was largely unchanged from the prior year. The percentage of cash and short-term investments, corporate bonds, and total other investments decreased slightly while the percentage of total other securities increased proportionately.

Comparing 2003 to1997 highlights the redistribution of assets from traditional asset classes to other types of securities. Although the percentage distribution of most asset classes held relatively stable over the period, total other securities increased sharply while federal government securities decreased significantly.

The systems are investing larger proportions of their funds in alternative asset classes such as: investments held in trust by other agencies, securities of state and local governments, foreign and international securities, shares held in mutual funds, conditional sales, contracts, direct loans, loans to members and the like. There are several possible reasons fund managers are opting for some reallocation—low interest rates; the downturn in the stock market; emerging markets abroad; and opportunities in private equity offering growth opportunities.

Current Issues

Funding considerations dominate discussions concerning public employee retirement systems. System administrators must earn consistently high yields to keep up with their actuarial liabilities. Poor investment returns require systems to either increase employer contributions or limit benefits, both difficult measures.

The recent stock market decline, changing demographics, and the increasing costs of health care have placed considerable burden on retirement systems, making it difficult for some to keep up with their actuarial liabilities. As in the private sector, some state governments are considering switching retirement structures from defined benefit to defined contribution to minimize the government's exposure to market risk. Others are utilizing alternative investments and increasing their role in corporate governance to ensure they reap maximum returns on their investments. This section will address the funding problems now facing systems, the alternative benefit structures they are considering, and some of the alternative investment solutions they are employing.

Funding Levels

Most public pensions are pre-funded, meaning assets for retirement benefits accumulate during a participants pre-retirement years.[3] An actuarial funding level can be used to gauge a pre-funded plan's health. This is calculated by dividing the plans assets by its liabilities for accrued benefits. A fully funded pension plan has assets equal to its liabilities and a ratio of 100 percent. A system whose assets are less than its liabilities is underfunded. This does not mean that the system will not be able to meet its benefit obligations, but that it will need more funding to meet them in the long term.

The Public Fund Survey, conducted annually by the National Association of State Retirement Administrators (NASRA), showed a significant decrease recently in the actuarial funding level for the 125 state retirement systems included in the survey: 91.1 percent in 2003, down from 96.3 percent in 2002, and 100.9 percent in 2001.[4] The research director for NASRA cited two factors causing the drop in this ratio: the declining equity market and the generous benefit enhancements of the late 1990s.[5]

Other factors related to system funding issues are increasing life expectancy and underpayment by the government, especially during times of fiscal stress and rising health care costs. With many systems providing health care benefits to their retirees, this is becoming an important financial factor since healthcare costs are growing rapidly and are difficult to predict. In fact, *The Economist* magazine reports that the future burden of healthcare costs could easily be as great as the cost of pensions.[6]

Changing demographics exacerbate these problems. Systems have more retirees, who are in turn living longer, increasing the ratio of annuitants to active members. Annuitants typically require more service than active members, increasing administrative expenses and placing a strain on funding. More annuitants also require plans to be more liquid to be available to pay benefits, inevitably placing assets in less lucrative classes leading to smaller returns.[7]

Defined Benefit and Defined Contribution Plans

Due to the financial problems defined benefit plans are now facing, both public and private sector employers are examining alternative structures to relieve their pension burdens. These include defined contribution plans, such as 401(k)s, and hybrid systems.

In a defined benefit retirement plan, the payments an employee receives upon retirement are defined by an agreement between the employer and the employee. In a defined contribution plan, the contributions the employee and employer make are defined; however, the end retirement benefits depend upon the growth of the contributions rather than an agreed upon allotment.

Defined benefit plans have several advantages for employees. Primarily, they shift the market risk to the employer, which gives employees greater financial stability in retirement. In addition, many plans protect against inflation by earmarking benefit payments to some measure such as the Consumer Price Index. There are also disadvantages for the employees; since these systems are typically structured to reward longer service, the rules of defined benefit plans usually hinder a member's mobility.

Employers benefit by offering defined benefit retirement plans because their stability helps attract and retain a quality workforce and increase diversity.[8] This comes at a financial cost, however, since employers take on the market risk.

Defined contribution plans offer employees more career mobility and greater control over their retirement planning. Smart investing and saving could provide greater returns; however, because professional fiduciaries rather than individual members administer defined benefit plans, members in defined contribution plans typically earn lower rates of return.[9] Employees also shoulder the market risk so their benefits are not guaranteed.

Defined contribution plans effectively shift the market risk from the employer to the employee, a major advantage for employers. Since defined contribution plans are often not as appealing to perspective employees, in a competitive employment market this can make attracting and retaining employees more difficult.

Some private pension plans are developing hybrid systems, attempting to share the market risk between both the employer and the employee, which might be adapted by public systems in the future. GE, for example is developing a system that would allow defined contribution participants to invest their money in a fund which would mirror the GE defined benefit plan investment lineup and provide for a minimum 5 percent guaranteed return.[10]

Move to Alternative Asset Classes and Corporate Activism

In addition to examining alternative retirement offerings, pension funds are turning to alternative investments and corporate activism to ease their funding problems. Pensions and Investments magazine reported, "CalPERS moved approximately 17 billion to alternatives at the expense of traditional asset classes over the past three or four years."[11] This constitutes nearly 10.0 percent of its $170.7 billion in asset holdings. Other funds are considering similar moves into alternative investments. CalSTRS, for example, is considering hedging, emerging market bonds, and other non-traditional assets as a way to generate greater returns.[12]

State public employee retirement funds are also increasing their role in corporate governance to assure that businesses act in ways that best benefit the financial interests of the systems. This movement began in the early 80's when CalPERS began publishing "focus lists" of companies with bad corporate governance.[13]

Fiduciaries have continued to take a growing interest in utilizing their shareholder rights. NASRA has asked the Securities and Exchange Commission to allow proxy voting reforms that will help them, "exercise the rights of shareholder ownership in order to promote the best economic interests of plan members and beneficiaries."[14] NASRA says, "(their) best alternative is to address problematic situations by improving the boards to reflect an appropriate shareholder perspective."

Perhaps the best-known recent example of a pension fund using its proxy rights to influence the direction of a corporate board occurred this year when CalPERS led a campaign against the Disney Corporation chairman and succeeded in stripping him of his role.[15] With such large asset holdings, many of these systems control large portions of major corporations. It will be interesting to watch their influence on corporate governance over the next several years.

Author's Note

This article is released to inform interested parties of ongoing research and to encourage discussion of work in progress. The views expressed on technical issues are those of the author and not necessarily those of the U.S. Census Bureau.

Notes

[1]Table 1: Annual Estimates of the Population for the United States and States, and for Puerto Rico: April 1, 2000 to July 1, 2004 (NST-EST2004-01), Source: Population Division, U.S. Census Bureau, (Release Date: December 22, 2004).

[2]Vince Calio, "Mega Funds," Pensions & Investments, (September 20, 2004) P&I/Watson Wyatt World 300. Ranked by U.S. dollars, in millions. U.S. fund data is from the P&I 1000, published January 26; all other fund data as of December 31, unless otherwise noted.

[3]Keith Brainard, "Public Fund Survey Summary of Findings FY 2003," (September 2004).

[4]Rob Kozlowski, "Funding levels for Public Plans fall in FY03," *Pensions & Investments*, (November 1, 2004).

[5]See note 3 above.

[6]"Enough to live on," *The Economist*, (March 25, 2004).

[7]See note 3 above.

[8]Gary W. Anderson and Keith Brainard, "Profitable Prudence: The Case for Public Employer Defined Benefit Plans," (April 26, 2004).

[9]See note 2 above.

[10]Phyllis Feinberg, "DC offering linked to GE pension plan on the way," *Pensions & Investments*, (August 9, 2004).

[11]Christine Williamson, "CalPERS separates alpha, beta," *Pensions & Investments*, (November 15, 2004).

[12]Joel Chernoff, "CalSTRS joins hunt for alpha," *Pensions & Investments*, (July 12, 2004).

[13]"Profit huggers," *The Economist*, (April 1, 2004).

[14]Letter to Mr. Jonathan G. Katz, Secretary of Securities and Exchange Commission, from NASRA, December 22, 2003.

[15]Paul R. La Monica, "Eisner out as Disney chair," *CNN Money*, (March 4, 2004). http://money.cnn.com/2004/03/04/news/companies/disney/.

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