Pension Fund Sustainability: Topics for Exploration

Michael Perri and Michele Berry, consultants with Lincoln Crow Strategies, facilitated pension sustainability discussions with the Board, with the purpose of initiating the first goal set out in SERS’ FY2020-2024 Strategic Plan: Pension Fund Sustainability: SERS’ pension fund is designed to be sustainable and adaptive to meet the needs of its members, employers, and retirees.

To maintain sustainability and adaptability, the Board was interested in beginning regular discussions on plan design to make sure the System is in position to withstand changes in member demographics, investment experience, and financial pressures. Working from the position of a healthy pension fund, the Board wants to take the time to be prepared to strengthen the system without any financial or legal imperatives to act on.

At the retreat, Board members reviewed each other’s expectations and visions of the sustainability initiative, prioritized plan elements that require further investigation, and began the iterative process established a common definition of “sustainability” that will aid in planning efforts.

Perri and Berry conducted several exercises to help Board members foster creative thinking, and strengthen their ability to work together and analyze complex issues.

The Board members began the retreat by reflecting on what they have learned about this process. Several Board members stated that the sustainability discussions are difficult because changes directly affect people’s lives, and that each member of the Board has a vested interest in the pension fund. They committed to thinking outside the box, being open to new and different ideas, to respecting differences of opinion, and working together to tackle tough questions.

Next, the Board members discussed in small groups, as well as in a larger group setting, what they believe “sustainability” means. Board members’ definitions of sustainability included being able to provide pensions earned through years of contributing service, and exploring long-term funding beyond the state-mandated 30-year funding window. They said the sustainability initiative has to look beyond the 30-year actuarial assumptions to make sure there is some retirement security for those who earn it.

Finally, Perri and Berry assisted the Board members in prioritizing topics for investigation during the next phase of the initiative, which will take place in the fall. Potential topics for exploration included:

- What is the current state of SERS, and what does it that mean for a sustainable future?
- How do the many forms of risk involved in providing retirement benefits impact sustainability?
- How do current actuarial assumptions impact our vision of the future?
- What will be the impact of changes in Ohio demographics on our educational system?
- How does pension system cash flow impact the ability to provide sustainable benefits?
- What type of plan changes have other systems made or are proposing to make themselves more sustainable?
- What possible new pension plan designs have other systems made or are exploring to make themselves more sustainable?
- What is SERS’ primary purpose?
Board members agreed that actuarial assumptions, SERS’ purpose, and changing demographics are the most important topics to explore during the next phase, and that a discussion surrounding the purpose of SERS as a pension system needs to take place before addressing the other elements.

Perri and Berry will devise a proposal containing the Board’s next actions, and present it at the September Board meeting.

**Investment Outlook, Growth Valuations, and Trade Wars**

David Lebovitz, executive director and global market strategist, for J.P. Morgan Asset Management, provided the Board with an overview of the global economy and the worldwide state of money management.

**U.S. Economic Expansion**

Lebovitz noted that the U.S. is now in the longest economic expansion in the nation’s history at 120 consecutive months. While this period is notable for its length, it’s also notable because its overall strength is disappointing when compared with previous expansion periods.

One reason for the sluggish U.S. economic growth is that the number of people working and worker productivity have been under pressure during the expansion. The best way to stimulate economic growth is to increase hiring and worker production, but during the expansion, companies have been putting profits into shareholder hands rather than investing in their workforce.

**Inflation**

One economic force that has remained low for an extended period is inflation. Lebovitz believes that inflation should continue to remain low because the price of goods has come down over the last 15 years, due to what he termed the “Amazon effect.”

He said that inflation began to rise a few years ago but the crash in energy prices effectively reversed inflation’s upward trend.

**Federal Reserve**

The main player in the country’s market activity and economic stability is the Federal Reserve (Fed). Recent reports indicate that the Fed could lower interest rates up to three times next year. These cuts could weaken the U.S. dollar which could boost returns from international assets. Lebovitz believes there is some disconnect between the Fed and the markets, and he suggests it seems as if the markets are moving the Fed’s hand, which is contrary to the way it normally works. It is also possible that the Fed is making moves now to avoid any moves during the upcoming election year.

**Trade Wars**

With the recent tariff increases on Chinese imports, the U.S. moved from one of the lowest tariff countries in the world to about average. Lebovitz believes the biggest risk in a trade war with China is that it could escalate even further. Any escalation could further reduce economic growth in the U.S. due to manufacturing layoffs and a reduction in worker output.

**Investment Opportunities**

According to Lebovitz, the U.S. is still a good place for investors. The U.S. economy is continuing to grow, albeit slowly, which means that equities will still produce returns, just at a slower rate.
Even though corporate earnings growth has leveled off globally, international equity valuations are below average which represents an opportunity for investment returns. However, another opportunity for investment income in the near future may be in emerging markets.

Finally, it seems that fixed income investments have peaked so there is not much room for more income.

**Health Care Sustainability: How Did We Get Here and Where Are We Now?**
Michael and Emily Madalena of Madalena Consulting, LLC, an independent health care consultant, along with members of the SERS Health Care Services Staff, presented the Sustainability Review: 2019.

**How Did We Get Here?**

The presentation examined SERS financial status over a 10-year period in relation to health care expenses and actuarial projections. Michael Madalena noted for the Board that the Health Care program’s financial status is stable, and it is positive that long-term strategies can be considered thoughtfully, without the pressure of a fiscal emergency.

Discussion ensued regarding different measures of financial solvency, which included an entity’s ability to pay for a percentage of its future expenses, SERS’ current funding policy, and actuarial valuation of future solvency. A timeline of historical health care changes, subsidization, enrollment, eligibility, and other landmarks also was reviewed.

One of the topics examined was the fact that if SERS were to make changes to the health care program to extend plan longevity, not all changes would have equal effect. Specifically, the premium subsidy was identified as the most significant and impactful area of change available to decision makers. Subsidy changes which “grandfather” or protect current retirees have less effect than those which apply to all current enrollees. The SERS Board has made changes in subsidy which have been both prospective and retrospective at different times in the program’s history.

Further analysis of the premium subsidy and its history showed that SERS’ health care subsidy is worth $95 million per year to members. While 48% of subsidy dollars were in the Medicare population, 52% were in the non-Medicare population, even though the non-Medicare population only accounts for 12% of all enrollees. This is partially due to the fact that the base premium for non-Medicare is over six times more expensive than Medicare. Of the non-Medicare enrollees, 99% are receiving a subsidy.

Staff observed that service retirees accounted for 86% of subsidy dollars while health care enrollees with more than 20 years of service accounted for 92% of subsidy dollars. The current subsidy structure, in place since 2011, provides the most benefit to disability benefit recipients and retirees with higher years of service.

The presentation also made note of SERS’ unique demographics. Compared to its sister systems, SERS’ membership was older, mainly female, had fewer years of service, and had markedly lower salaries. The Medicare and non-Medicare Program plans also were compared and examined by expenses, claims, and enrollment.

**Where Are We Now?**

Based on the analytics gathered to create the presentation, it became clear that subsidization drives enrollment, which drives demographics, which drive expense distribution.

The program’s expenses were reviewed, also noting that the current level of reimbursements from Medicare for both medical and prescription drugs substantially offset expenses and the Medicare program, if measured independently, would be solvent indefinitely.
Another issue of consideration is the need for SERS to review the existing Guiding Principles document as part of future health care sustainability discussions.

Further discussions related to health care sustainability will take place during the September Board meeting.