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BARRIERS TO SOUND POSTAL PENSION RISK MANAGEMENT

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INTRODUCTION

Defined-benefit pension plans have been offered by U.S. government bodies to their workers for generations. These plans offer retirement income and healthcare payments outside the Social Security and Medicare plans that cover most citizens once they reach the age of 65. These plans commit to a defined amount of income, based on factors such as end-of-career salary and years of service. They differ greatly from the 401(k) plans available to most private sector workers where retirement income is a reflection of money workers save in employer-sponsored plans throughout their working lives. Such savings-based retirement mechanisms are called "defined contribution" plans.

Defined-benefit plans operate under the assumption that government savings can reap returns over time. Indeed, such plans are some of the largest investors in the nation's debt and equities markets. These funds seek market returns on assets to grow invested money and ensure that promised funds will be available as current employees age out of the workforce. Rather than to devote current budget dollars to pay for past employees (as Medicare and Social Security do), they allow government bodies to save vast sums of money in advance.

These funds require returns both to meet growing liabilities and account for nominal changes in the cost of living. Without such returns, government savings will lag behind increases in liabilities and become insolvent in the long run, which forces benefit reductions for members of the plans. To reap returns, pension funds must take on some level of risk, but how much risk is appropriate is a topic of continued debate. Higher returns require more risk of loss and subsequent need for benefit cuts. By agreeing to take on more risk, politicians decrease the amount they must sock away for employees who retire in the future, freeing money for other spending priorities today.

Yet, not all defined-benefit plans are the same. The U.S. Postal Service (USPS), for example, operates defined-benefit pension plans that are limited by a different set of rules than those faced by other government savers. These seek to minimize risk in postal retirement benefits to prevent the need for money to be drawn from other postal spending to pay already promised pensions to former employees. This conservative approach has meant the agency rarely, if ever, loses money on pension investments, but it also fails to profit like other pension plans when the economy is growing. The resulting money "left on the table" has spurred calls to liberalize postal pension investment rules to allow market returns rather than increased savings by the Postal Service.

Long-run returns in excess of retirement needs would give the postal service some financial breathing room to cope with other challenges in the postal market in the next twenty years. At a minimum, it could prevent the need for the USPS to take money from other capital needs, like new mail trucks, better mail-handling equipment and maintenance of its buildings. Further, with pensions fully funded, new possibilities to improve retirement benefits would emerge, including devolving responsibility for postal pensions to a combination of union-sponsored plans and 401(k)-style options for non-union employees.

POSTAL PENSIONS TODAY

The retirement funds of the United States Postal Service find themselves in a unique position among their peers in state and municipal government. Unlike other funds, the Postal Service is bound by federal law that limits risk-taking with pension dollars. There are three such funds: the Civil Service Retirement System (CSRS), the Federal Employee Retirement System (FERS) and the Postal Service Retiree Health Benefits Fund (PSRHBF). The former two cover retirement income; the latter covers retirement healthcare expenses. The CSRS is currently closed to new entrants and thus subsequent hires are covered by the FERS. In 2016, these funds had a collective shortfall of more than $73 billion with more than $50 billion in unfunded liabilities for the

TABLE I: ESTIMATED SURPLUS (DEFICIT) AFTER 20 YEARS—50TH PERCENTILE

Portfolio	Risk Level	CSRS	FERS	PSRHBF
Current Investment *Special purpose treasuries*	Very Conservative	(31)	(40)	(57)
Traditional *Publicly traded stocks and bonds*	Conservative	5	8	(29)
	Medium Risk	58	63	1
	High Risk	114	119	35
Alternative *Publicly traded stocks and bonds plus non-traditional asset classes including high yield bonds, emerging market bonds, private real estate, private equity, and multi-asset solutions*	Conservative	44	51	(6)
	Medium Risk	124	127	40
	High Risk	193	198	78

SOURCE: USPS OIG Report, p. 3. https://www.uspsoig.gov/sites/default/files/document-library-files/2017/FT-WP-17-001.pdf.

PSRHBF alone.[1] The retirement income funds fare better but are still underfunded to the tune of more than $17 billion for the CSRS and another $3.8 billion for FERS.[2]

A recent study by the Center for Retirement Research found that since 2001, the average public pension plan earns market returns of approximately 5.5 percent annually below the assumed return on investment.[3] The difference is attributed to different returns on different types of asset classes across plans. However, the Postal Service does not have the luxury of a diversified investment portfolio that earns 5.5 percent annually. This is because by law, postal pension funds must be invested in financial products offered by the U.S. Treasury. These products are deemed essentially riskless investments because the principle is backed by the full faith and credit of the U.S. government. Any risk comes from inflation and reinvestment, that is, from rising prices and the potential for lower interest rates when securities mature and must be reinvested. This limitation on risk has prevented the agency from earning returns at the level of other government entities.

Current special purpose Treasury securities owned by the postal retirement funds earn as little as 1.4 percent interest and as much as 4.7 percent depending on the year of maturity.[4] The difference between this percentage and the 5.5 percent return on pension funds owned by entities allowed to invest in a broader groups of assets is money that amounts to foregone returns of millions of dollars per year.

In 2017, the Postal Service's Inspector General (USPS OIG) sought to understand the extent of the underfunding that is caused by legislative limits on the financial products the retirement funds are permitted to invest in. To do so, the Office commissioned a study that used actuarial modeling to forecast the likely pension deficit under a variety of scenarios, if the rules currently governing the agency were changed to allow a more risky investment strategy.[5]

According to the study, under current regulations, all three postal retirement funds would be underfunded to some degree after 20 years.

If the postal retirement plans are allowed to invest in traditional stocks and bonds, however, even under the least risky portfolio, only the most underfunded of the three plans would remain that way on average. The other two, on average, would be funded to slightly over 100 percent.

Opening investment options to non-traditional assets like real estate, private equity and higher-yield bonds would be expected to improve the funding levels even further. While there is a chance of losing money, the USPS OIG analysis found that losses under the current regulations would be greater than even the "high risk" portfolio of traditional, publicly traded stocks and bonds for all asset classes in both best-case and worst-case simulations (Table 2).

The report for the inspector general makes clear that risk from low pension investment returns can be just as damaging as risk of loss itself. Postal law that mandates extra-conservative use of postal savings puts letter carriers and postmasters at greater risk of retirement income being reduced in the indeterminate future. Changing this policy and applying pension investment rules typical of other government employers is thus a minimally-controversial postal reform option for federal legislators.

TABLE 2: SUMMARY OF SIMULATION RESULTS—SURPLUS (DEFICIT) AFTER 20 YEARS ($BILLIONS)

		CSRS			FERS			PSRHBF		
Portfolio	Risk Level	Bottom 5%	Median 50%	Top 95%	Bottom 5%	Median 50%	Top 95%	Bottom 5%	Median 50%	Top 95%
Current Investment *Special purpose treasuries*	Very Conservative	(90)	(31)	23	(129)	(40)	41	(174)	(57)	33
Traditional *Publicly traded stocks and bonds*	Conservative	(69)	5	107	(84)	8	130	(155)	(29)	86
	Medium Risk	(75)	58	297	(90)	63	300	(144)	1	165
	High Risk	(81)	114	584	(100)	119	550	(138)	35	289
Alternative *Publicly traded stocks and bonds plus non-traditional asset classes including high yield bonds, emerging market bonds, private real estate, private equity, and multi-asset solutions*	Conservative	(44)	44	174	(55)	51	199	(138)	(6)	118
	Medium Risk	(49)	124	428	(51)	127	423	(122)	40	213
	High Risk	(68)	193	784	(68)	198	731	(116)	78	386

SOURCE: USPS OIG Report, p. 10. https://www.uspsoig.gov/sites/default/files/document-library-files/2017/FT-WP-17-001.pdf

MOVING FORWARD

Liberalizing pension investment rules would give the postal service some of the flexibility it needs to adapt in a changing postal environment. For instance, the money could allow a reduced employer contribution for future retiree expenses, which would free money to invest in new buildings and equipment that would help the agency increase productivity and lower non-pension costs over time. Better still, current funding levels going into postal retirement plans could be maintained while transitioning new employees to defined-contribution retirement plans. Any excess funds could be held to cover any unforeseen increases in expenses, as the current retirement accounts are phased out.

If workers wish to maintain the existing defined-benefit plans, full funding brought on by liberalized investment rules would open the door for the funds to be shifted to management by the labor unions to which most postal employees belong. In doing so, the risk of taxpayer bailout would be lower than today. Moreover, it would align the incentives of postal employees, their unions and the federal government, which could yield further value as retirement plan investment strategies are allowed to adapt to worker preferences for how their retirement dollars are managed.

CONCLUSION

Full funding of existing postal worker pension plans is something all involved parties (the Postal Service, Congress, postal unions and outside analysts) can get behind. Rules that seek to prevent financial losses of postal retirement funds have done the opposite, allowing unfunded liabilities to grow over time. What's more, to bring full funding to postal retirement funds does not require new spending. Rather, it simply requires postal pensions to be invested in the kinds of assets popular among other pension funds. The choice stands with Congress. Either the postal service can take on risk with the potential for return or it will risk being unable to pay its retirement obligations.

ABOUT THE AUTHOR

Nick Zaiac is a fellow in commercial freedom at the R Street Institute. His research focuses on postal, freight, transportation and other related issues.

ENDNOTES

1. Office of the Inspector General, United States Postal Service, "Postal Service Retiree Funds Investment Strategy," Report Number FT-WP-17-001, Sept. 20, 2017 [hereinafter USPS OIG Report]. https://www.uspsoig.gov/sites/default/files/document-library-files/2017/FT-WP-17-001.pdf.

2. Ibid.

3. Jean-Pierre Aubry et al., "What Explains Differences in Public Pension Returns Since 2001?", Center for Retirement Research, July 2018. http://crr.bc.edu/briefs/what-explains-differences-in-public-pension-returns-since-2001.

4. Ibid., p 12.

5. "Retiree Funds Investment Strategies," Segal Consulting, June 22, 2017. https://www.uspsoig.gov/sites/default/files/FT-WP-17-001_01.pdf.