Analysis of the Proposed Legislation for Changes to the State Retirement Systems: Small Steps in the Direction of Reform, but an Incomplete Effort to Fix the Problems

To: **Members of the Joint Committee on Pension Systems Review**

From: **Anthony Randazzo**
Managing Director, Pension Integrity Project

The legislative proposal approved by the Joint Committee on February 8, 2017 provides for many improvements to the funding practices for SCRS and PORS relative to the status quo. The members of the Joint Committee should be commended for your efforts to date. At the same time, however, the proposed changed would perpetuate some of the very practices that have caused the funding crisis facing SCRS and PORS today. As a result, we find that ***the legislative proposal is positive, but insufficient to fix the problems facing South Carolina retirement systems today and in the future***.

In the letter that follows we provide detailed analysis of each part of the proposed legislation. In summary, we forecast the following:

- Unfunded liabilities will continue to grow for SCRS and PORS without additional changes. They will grow slow than without changes, but they will still be over $30 billion for SCRS by the 2030s.
- The state will fall back into the pattern of underfunding pension benefits by paying only a statutorily determined rate instead of an actuarially determined rate.
- Average investment returns will continue to underperform the assumed rate of return, leading to unfunded liability growth.

The primary remedies to preventing these problems from persisting would be to:

1. <u>Adopt a new retirement plan design</u> for future hires in SCRS and PORS that are fully funded from its creation and that minimize the growth of liabilities for the system;
2. Put the state on a trajectory towards an assumed rate of return of 6% or less;
3. Allow for employer contribution rates to be determined by actuarial valuations in fiscal year 2023-24 and thereafter. This will allow a phase-in of contribution rate increases (as currently proposed) but then avoid the problems created by statutorily fixed rates for the long-term; and
4. Creating closed amortization schedule for unfunded liabilities with a fixed date so that today's unfunded liabilities paid off.

We recognize the political and technical challenges of considering the many moving parts associated with pension reform. One of those moving parts is the decision to separate the conversation about funding the current system from the retirement plan design for new hires. In that respect, we would encourage the Joint Committee to continue with the process of funding pension reform and discuss a new retirement plan for future public sector hires that will ensure retirement security all, while minimizing volatility and providing for stable contribution rates.

It has been said many times during the public hearings of the Joint Committee that there is as universal desire to formulate a comprehensive pension reform plan now to avoid having to address these issues again in the future. As long as the work of the Joint Committee continues beyond the proposed funding policy legislation, that goal can still be achieved.

Overall, our analysis indicates that SCRS and PORS will be better off with the proposed changes than with the status quo. However, ***if all that is accomplished is adoption of the proposed funding policy and governance changes, the goal of achieving comprehensive pension reform for SCRS and PORS will not be achieved — and members of the General Assembly will find themselves returning to confront the same challenges a few years down the road. Our analysis indicates that the proposed funding policy changes alone would not create a path for sustainability or solvency.***

Our comments attached to this letter are an analysis of the proposed funding policy provisions, while assuming that the Joint Committee will continue its work on new hire plan design.

We look forward to continuing to work with members of the Joint Committee on this important issue. Please do not hesitate to contact us directly with any questions.

Anthony Randazzo
Managing Director
Pension Integrity Project at Reason Foundation

anthony.randazzo@reason.org
P: (347) 871-6460

Analysis of the Joint Committee on Pension Systems Review Proposed Legislation as Published on February 8, 2017[1]

I. Employer Contribution Rate

- **Improvements: Increased contributions**
  - The planned increase in the employer contribution rate for SCRS and PORS will increase the assets to pay for the promised pensions of the state pension plans. The current funding method for SCRS and PORS has kept contribution rates low, therefore the increases are helpful.
- **Weakness 1: Statutory limits on contributions**
  - One of the reasons why South Carolina's pension systems are underfunded is that the contribution rate has been set in statute instead of simply being defined by actuarial determination. Sections 9-1-1085(A) and 9-11-225(A) perpetuate this practice.
  - It is reasonable to develop a schedule to phase in increases so that pension contributions do not crowd out expenditures on public goods and services. However, Sections 9-1-1085(A) and 9-11-225(A) fix in statute what contribution rates will be for the employer even after the phase-in.
  - The legislative language includes provisions allowing for the PEBA board to increase the contribution rate on the basis of the actuarial valuation, but by no more than 50 basis points in a given year unless the change in contributions is related to the amortization schedule — see 9-1-1085(B) and (C)(2), and 9-11-225(B) and (C)(2).
  - This may not be sufficient to fully fund the system. Therefore, the statutes as amended would perpetuate the existing problem for SCRS and PORS.
- **Weakness 2: Lowering the funded status threshold for reducing contributions from 90% to 85%**
  - Current statutes require that the funded status of a given pension system (SCRS or PORS) must be 90% funded before contribution rates can be decreased. The most responsible statute would require 100% funded as a threshold before employer contributions can be reduced, however a 90% threshold is within tolerable limits of acceptable practice.
  - However, the proposed legislation needlessly would reduce the funded status threshold to reduce employer contributions from 90% to 85%. If anything, the contribution minimum cap should be increased, not decreased, since the objective of pension reform is to attain plan solvency.
- **Alternative Ideas: Allow for contributions to be actuarially determined after fiscal year 2023-24 and not reduced until 100% funded**
  1. The schedules adopted for SCRS and PORS increase contribution rates by 200 basis points in year 1, and 100 basis points each year there after until fiscal year 2022-2023. Beginning in fiscal year 2023-24 the contribution rates for both SCRS and PORS should be determined by the actuarial valuation based on the funding methods and assumptions otherwise established in statute and by PEBA.
  2. Increase the threshold for when employer contributions can be decreased from 90% to 100%. Cost/savings: This would not require any additional contributions.

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[1] Text analyzed can be found at: http://bit.ly/2lyKmPn

II. Unfunded Liability Amortization Schedule

- **Improvement: Reducing the years in the schedule**
  - SCRS has been amortizing unfunded liabilities over a 30-year period for more than a decade (with 29-year schedules used in 2007 and 2012). This is outside of best practices embraced by the actuarial community and has resulted in "negative amortization" whereby the amortization payments made not have covered the interest accrued on unfunded liabilities in a given year.
  - Adopting a plan to reduce the years in the schedule to 20 years by fiscal year 2027-28 will significantly improve the funding policy of the state retirement plans and reduce instances of negative amortization.
- **Weakness: Technically maintaining an "open" schedule**
  - One of the primary reasons why South Carolina's pension systems have become so underfunded is that the unfunded liability amortization schedule has been the "floating" method where by the amortization schedule can be re-set to a 30-year period each valuation year. In effect, this means it is unlikely unfunded liabilities will ever be paid off. Sections 9-1-1085(C) and 9-11-225(C) perpetuate this practice.
  - While the proposed changes reduce the years in the amortization schedule, thereby increasing the amortization payments, there is no expressed provision that ensures the funding period will be 20-years.
- **Alternative Ideas: Adopt language that provides for a clearly defined fixed date by which today's unfunded liabilities should be paid off; and amortize any future unfunded liabilities over annual, separate 20-year schedules**
  1. The preamble of the proposed legislation says that a purpose of the bill is "to require that the unfunded liabilities of the system must be on a certain amortization schedule." This would be best accomplished by including language indicating that all unfunded liabilities accrued as of this current year should be paid off by the fiscal year 2047-48 (i.e. 30-years from now).
     - As the language currently stands it could be interpreted as to allow for a continued use of the "open" amortization method whereby after fiscal year 2027-28 the funding period will remain 20-years for every year thereafter. Clarity in the language would help to ensure the bill's purpose of providing a "certain" schedule is accomplished.
  2. Under this approach of adopting a specific date to pay off existing unfunded liabilities, the legislation could clarify that all unfunded liabilities accrued on future accrued liabilities be amortized over individual 20-year schedules each year such that there are layers of amortization schedules to space out the additional employer contributions required from not meeting actuarial assumptions.
  3. Further clarity in intention could be provided by explicitly requiring that amortization payments are at least enough to pay for any interest accrued on unfunded liabilities.

III. Assumed Rate of Return

- **Improvements: Creating a process for lowering the assumed return**
  - The process of reviewing the assumed rate of return every four years (outlined in Section 9-16-335(B)) is a reasonable approach to ensure regular review of assumed rate of return via a legislative process.
- **Weakness 1: Only lowering the assumed return to 7.25% for the next four years**
  - One of the primary reasons why South Carolina's pension systems have become so underfunded is that investment returns have underperformed the long-term assumed rate of return.
  - The average return for SCRS over the past 10-15 years ranges from 4.4% to 5.0%. Expectations used by PEBA in assessing the cost/savings of proposed pension reforms assume that average return by RSIC will be only 4% over the next four years. The investment advisor for CalPERS, the largest pension system in the U.S., has said the state should only expect 6.2% returns over the next decade. Collectively, this suggests that the state should be adopting a much more realistic target than 7.25%.
- **Weakness 2: No provision for changes within a four-year period**
  - It is reasonable that a regular schedule for reviewing the assumed rate of return be established on a four-year basis. However, should market conditions warrant, there should be some provision in Section 9-16-335 that would allow RSIC to recommend the General Assembly revise the investment return assumption for SCRS and PORS within an established four-year period.
- **Alternative Ideas: Adopt an assumed return of 6.75% to start; provide a maximum assumed return rate; require further probabilistic analysis disclosure; allow for emergency rate change recommendations**
  1. Lower the assumed rate of return effective July 1, 2017 to 6.75%. The additional contributions required by this could be phased in using the same schedule already established, but by increasing the employer contribution by 200 basis points annually until reaching the actuarially determined contribution rate.
     - 6.75% would send a message that South Carolina is serious about addressing its unfunded liability issues. California's largest plans recently announced they are moving to a 7% assumption; Connecticut recently announced their state employee plan is moving to a 6.9% assumption. Targeting a return that is 6.8% or less would make South Carolina a leader in moving forwards a more fiscally prudent funding approach for pension plans in America.
  2. Make the change in the assumed return — whether the 7.25% rate in the current legislative draft or the 6.75% rate recommended here — a maximum rate such that the future recommendations cannot exceed that cap.
  3. Require that each year that RSIC issues a recommendation to the General Assembly that they provide analysis of the probability that the recommended rate will be achieved and that they explicitly defend why it is reasonable to assume a return greater than 6%.
  4. Adopt a provision that would allow RSIC to recommend a change to the assumed rate of return before the usual four-year review period if market conditions warranted.

IV. Employee-Employer Cost Sharing

- **Improvements: Employee retention is more likely**
    - Without amending the cost-sharing differentials for employees and employers (2.9% for SCRS and 5% for PORS), employee contributions would need to grow to over 15% of compensation over time. It is reasonable to conclude that this would create significant retention challenges for state and local employers, in addition to problems with recruitment.
- **Weakness: No replacement mechanism to control for taxpayer liabilities**
    - The explicit cost sharing between employees and employers is one of the best governance components of SCRS and PORS. The maximum differential between employees and employers creates a political incentive to adopt responsible funding policy and fully fund the plan to protect employee benefits and contribution rates. The current recognition of the need to improve funding policy to avoid a spike in employee contributions rates is the kind of political incentive that the cost-sharing mechanism was designed to create.
    - While it is reasonable to change the cost-sharing mechanism to avoid that spike for employees, an alternative policy would have been to retain some cost-sharing element or to replace the cost-sharing differential with another mechanism to contain the growth of taxpayer liabilities, rather than just eliminate the cost sharing on its own.
    - There are few plans in the country embracing the funding incentives associated with cost-sharing, and this was one of the better policies associated with South Carolina's pension funding.
- **Alternative Idea: Adopt a new retirement plan for future hires that is fully funded from the start and that minimizes the growth of taxpayer liabilities**

V. Governance Reforms

- **Comments on changes to board composition (Section 9-4-10)**
    - Changes to board composition for PEBA will only be able to provide minimal support to the funding policy of SCRS or PORS if the board is constrained in how it can increase contribution rates.
- **Comments on changes to RSIC reporting schedules (Section 9-16-90)**
    - In addition to providing for fee schedules, RSIC should be required to report the probability of achieving the currently adopted assumed rate of return over a 10-year, 20-year, and 30-year period, as well as disclosing its methods for forecasting those returns. This information should also be included in the Comprehensive Annual Financial Report.
- **Comments on additional reporting**
    - In addition to the current "discount rate sensitivity analysis" included in Comprehensive Annual Financial Reports that provides the net pension liability using a discount rate 100 basis points above and below the current discount rate, PEBA should report the net pension liability for all pension systems/plans using a market value of total pension liabilities.