NTSA
National Tax-Deferred Savings Association
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Good morning Chairs Metcalfe and Cohen and Members of the House Standing Committee on State Government. Thank you for taking the time for my testimony. My name is Joe Nichols. I am a pension actuary with FTI Consulting. FTI Consulting provides independent, innovative advice to governments and businesses globally. I am also President-Elect of ASPPA, a sister organization with NTSA, part of the American Retirement Association. Opinions stated in my testimony today are mine and not those of FTI Consulting or ASPPA.

My professional background with pensions dates back to 1988, when I obtained my actuarial science degree. I started consulting to governmental entities regarding pensions in 1990. My public pension experience covers a wide range of plan sizes – from small municipalities to large state plans during a wide range of economic cycles.

In all of my experiences, there is one common element that separates sustainable pension plans from those with eventual cash flow issues – consistent funding. There are other factors that help plans succeed – good governance, affordable benefits, and efficient expenses – to name a few. However, rarely do any of these other factors solely affect the ability of the plan sponsor to pay promised benefits like consistent funding.

There have been multiple studies regarding Pennsylvania retirement systems over the last decade. All of these studies were precipitated by funding issues. However, instead of squarely tackling the funding issues, plan design changes were wrapped into projections that complicated the discussions and established funding collars that pushed contributions down the road – again and again. To make matters worse, the lower funding plan was not followed. In fact, over the last 12 years, Pennsylvania has only contributed 41%[1] of the suggested actuarial contribution amounts. Only New Jersey has contributed a lesser percentage than Pennsylvania over the last decade.

Pennsylvania's dismal funding history is not new to anyone on this committee. I repeat it here because funding is the topic of my testimony – not plan design, not budget, not even expenses – it is funding. Lack of adequate funding is the single largest contributor to the growth in unfunded liabilities. The growth in unfunded liabilities leads to credit downgrades, which leads to an increased cost of borrowing.

I have heard from people close to Pennsylvania policy circles that virtually everyone agrees benefits accrued to date by participants in SERS and PSERS cannot be decreased. Since the current underfunding is based on benefits accrued to date, the focus of current pension reform must be primarily on funding.

The other issues of pension reform, most notably, how future benefits are to be earned, mortality risk, investment risk, etc. should be separate issues and not used as leverage that keeps "kicking the can down the road." For example, the value of pension benefits earned annually in PSERS is approximately

[1]Spotlight on The Annual Required Contribution Experience of State Retirement Plans, FY 01 to FY 13
Keith Brainard and Alex Brown, National Association of State Retirement Administrators, March 2015

16%[2] of compensation. However, the employees pay for 7.5% of these benefits through their own employee contributions. This leaves an employer normal cost of 8.5%, which is only about 1/3 of the total employer contribution cost. Even if benefits were altered to cut the employer normal cost in half (to about 4%), the total contribution rate would only decrease by about 15%. For SERS, the cost of benefits is 11.25%[3] of compensation and employees contribute 6.25%, creating an employer normal cost of approximately 5%. Since the total contribution is 31.41% of compensation, cutting the employer normal cost by one half only decreases the total contribution by about 8%.

Let's look at this another way. The two plans have total unfunded liabilities of approximately $53 billion. If amortized over 30 years, as a level dollar amount, using a 7.5% discount rate, the annual payment would be just over $4 billion. Any contribution short of this amount is continuing the practice of passing the responsibility down the road. Many will argue that using a level dollar approach puts too much pressure on the current taxpayers. However, since over $15 billion in employer contributions have been skipped in the last few years, the sooner the unfunded liabilities are paid off, the less that gets unfairly pushed to future generations.

So, my suggestion is to first tackle how to pay for benefits earned to date. After that is tackled, then worry about the more polarizing issues that affect benefits to be earned in the future. More specifically whether the System's future structure should be Defined Benefit, Defined Contribution or a hybrid of the two.

So far, in this year's debate, a couple of suggestions have surfaced about how to fix the funding issue – pension obligation bonds and a move to passive investing. I am neither a bond nor investment expert. However, I have recently spoken with both and have an opinion on the issues. In regards to the pension obligation bonds, the current interest rate environment is definitely advantageous to the borrower. However, there is concern regarding timing and how any potential shift in the current environment might eliminate expected savings. Even if a POB transaction were to go exactly as planned, and assuming a 4.5% arbitrage in interest rates, the first year savings would generate approximately $135 million per year. Keep in mind that the first year's savings would be offset by transaction fees. Also note that many bond rating experts tend to be agnostic in regards to using POBs to fund pension plans – meaning it typically has no effect on the plan sponsor's credit rating.

The second suggestion is to switch investments in both plans from using active to passive management. There are very fervent arguments on both sides of this discussion, so any potential net expense savings are less determinable versus the POB discussion. However, those that favor passive investment management do admit that it is not prudent to invest in just one asset class or style. Asset allocation is still critically important. As a result, the savings cannot be determined by just comparing fees within any one asset class or style – fees in passive funds also vary for different asset classes.

Even if the purchase of POBs and a move to passive investing worked as planned, the amount of additional funds that result still only make up 10% of the contribution necessary to fully fund the

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[2] PSERS Actuarial Valuation as of June 30, 2014 – Buck Consultants
[3] SERS December 31, 2013 Actuarial Valuation – Key Results – Hay Group

unfunded liability. In an order of magnitude, the impact of funding far exceeds the impact of the next four items combined- future benefit accruals, investment returns and expenses, cost savings and plan design for future employees

In closing, I would like to again thank the committee for inviting me to testify. Actuaries are many times blamed for presenting complex, hard to understand solutions. Today, mine is easy. With the assumption that accrued benefits cannot be changed, there is no amount of plan design (whether DB, hybrid or DC) that will lower the contributions needed to pay off the unfunded liabilities. A funding policy that stops pushing responsibility to future taxpayers is the only solution. All other pension reform discussions are just noise until the funding of the benefits already earned are set and followed. Thank you.

Joseph A. Nichols, ASA, EA, MSPA, MAAA