



TESTIMONY

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ON THE PROPOSED HYBRID PENSION PLANS FOR MISSOURI GOVERNMENT EMPLOYEES

By Michael Rathbone

Testimony before the House Committee on Pensions

To the Honorable Members of the Committee:

Ladies and gentlemen, thank you for the opportunity to testify today. My name is Michael Rathbone, and I am a policy researcher for the Show-Me Institute, a nonprofit, nonpartisan Missouri-based think tank that supports free-market solutions for state policy. The ideas presented here are my own. This testimony is intended to provide information regarding hybrid pensions and items to look for when analyzing the financial impact of any pension reform plan in the state, more specifically in this case the impact of House Bill 485 (HB 485).

Introduction

The unfunded liabilities of the state's public pensions are an economic ticking time bomb. As of June 30, 2014, the Missouri State Employees Retirement System alone has more than \$2.8 billion in unfunded liabilities and is

only 75.1 percent funded.¹ There is good reason to believe that the plan's unfunded liabilities are even larger than the amount reported by MOSERS.² Because of these liabilities, the state faces a significant risk, and policymakers may be forced to make drastic cuts to services or significantly raise taxes in order to meet the state's pension obligations. The risk posed to Missouri's financial well-being is a real and serious one.

HB 485 seeks to address this problem by shifting new hires into a hybrid pension plan. A hybrid pension plan is one that contains elements of both a defined benefit (DB) plan and a defined contribution (DC) plan.³

Other Hybrid Plans

Hybrid plans are not new occurrences within the realm of public employee retirement. The federal government adopted a hybrid plan in 1986. Before the adoption of the hybrid plan (Federal

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A **defined benefit** plan is a plan that provides its members with a preset, guaranteed benefit based on an established formula that takes into account an employee's compensation, age, years of service, or a combination of all three.⁴

A **defined contribution** plan is a plan where the employer, employee, or both make fixed contributions of a certain percentage or amount into an account where the contributions, along with any investment earnings, finance the employee's retirement. Benefits are not guaranteed and the investment risk falls upon the employee.⁵

Employee Retirement System), federal government employees were enrolled in a defined benefit plan called the Civil Service Retirement System (CSRS). By 1982, CSRS had an unfunded liability of \$575 billion.⁶

The new hybrid plan had three basic components.⁷ These were:

1. Mandatory Social Security coverage of civilian federal workers
2. A mandatory DB plan with lower benefits than CSRS
3. A voluntary DC plan

Several factors played a part in successfully transitioning from the old CSRS system to the new Federal Employee Retirement System.⁸ These include:

1. Recognition that CSRS was an unsustainable plan
2. Limited the changes to new hires
3. Enrolling the employees into Social Security
4. Designing a DC plan that was free from political manipulation

Hybrid plans have been introduced at the state level as well. In 2011, Rhode Island recognized the need for reforming its pension system. An independent actuarial assessment of the state's pension system showed that the system's unfunded liabilities had risen to \$6.8 billion.⁹ Also during 2011, the state undertook major pension reform, including the adoption of a hybrid DB and DC plan.¹⁰

The DC portion of this plan had employees contribute 5 percent of their base pay into the DC fund in addition to their contributions to the DB part of their plan.¹¹ The state contributed 1 percent of employee salaries into the DC fund as well.¹²

The DB portion of the R.I. hybrid plan involved benefits being paid to workers out of a separate fund.¹³ This new plan prevents automatic increases to benefits unless the plan is 80 percent funded. Any subsequent increase in benefits will be indexed to the first \$25,000 in income and will be based on investment plan returns.¹⁴

Both of the hybrid reform plans illustrate that the adoption of such plans is not a radical new policy. In fact, the federal plan has been in place for decades.

HB 485

HB 485 aims to introduce a hybrid pension plan for new employees hired on or after January 1, 2016. It includes changes to the structure of the year 2000 retirement plan for state employees and elected officials along with the establishment of a DC component to the employee's retirement plan.¹⁵

The key question for the state, and by extension taxpayers, is whether this new plan will end up costing or saving the state money. A financial estimate is needed. However, it is important to note that there are some items to consider when examining the financial impact of pension reform legislation.

For example, the Committee on Legislative Research produced a fiscal note related to the financial impact of

HB 1682 from the previous legislative session.¹⁶ The note projected that total contributions over the 10 years following enactment of the legislation would increase by approximately \$151.3 million.

There are a few things that should be noted in regards to this fiscal note, and these items should be kept in mind when examining the financial impact of pension reform legislation going forward.

1. In regards to the fiscal note for HB 1682, it is impossible to understand how MOSERS came up with its assumptions without additional information. In any future fiscal note an explanation should accompany any assumptions made, detailing how they were determined.
2. After examining the fiscal note for HB 1682, there were three possible areas in which there is increased cost. They are:
 - a. Reducing the vesting period from 10 years to five years.
 - b. Reducing the employee contribution from 4 percent to 3 percent.
 - c. Requiring the employer to contribute 3 percent towards a DC plan.

If the vesting period and employee contribution areas are not changed then these costs will not be incurred. However, if the vesting period is decreased and/or employee contributions are reduced, these costs

can be offset by reductions in DB benefits. It is difficult to tell the amount of such a reduction without a more detailed financial analysis. It is also important to note that the fiscal note did not examine any cost savings that would accrue due to changes in future liabilities. Without a detailed actuarial report, preferably from an independent third party, it is impossible to determine the amount of savings (if any) that would occur.

GRS Consultants & Actuaries performed an actuarial analysis of a proposed hybrid plan for MOSERS in 2014.¹⁷ The key takeaway according to the report's authors is that establishing a new hybrid plan would lead to a 1.69 percentage point increase in normal costs for the plan (MOSERS). These new costs would be phased in as more new workers are phased in and older workers leave the system. However, in examining the report, the following should be noted:

1. This report contains no discussion of risk and uncertainty. This report assumes 8 percent returns to the system. However, 8 percent returns is NOT guaranteed for the portfolio. A key goal of hybrid plans is to reduce cost uncertainty. Policymakers should have asked the actuaries to run three feasible downside scenarios for both the current MOSERS plan and any proposed hybrid plan (e.g., discount rates of 7.5, 6.5, 5.5 percent) and see what the costs for both plans would be.¹⁸
2. It is not clear why the employer contribution rate in this report

was projected to decline in the note (See page 3 and the percentages under "Total Rate-Before Proposed Changes). My understanding is that MOSERS uses a 30-year closed, level percent of pay amortization schedule, and that the rate should be fixed at nearly 17 percent until the plan is 80 percent funded. MOSERS should clarify why this decrease is taking place.

A general point to note is that a hybrid plan will probably increase contribution costs in the short and medium term, but it should reduce cost uncertainty in the long run. It is important that any financial analysis of the impact of a new hybrid plan take the above-mentioned points into consideration when doing the analysis.

Conclusion

HB 485 is not breaking new ground in its attempts to reform public employee pensions. The federal government has been using a hybrid pension plan for its employees for decades. In regards to HB 485, we need to see how actuaries come up with their estimates when analyzing how much, if anything at all, it will end up costing the state or reducing future liabilities. Once all of the costs and benefits of the reform proposal are known, it will be for elected officials to decide whether a short-run increase in costs is an acceptable trade-off for any enhanced cost certainty in the future.

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NOTES:

¹ MOSERS 2014 Annual Report, <https://www.mosers.org/About-MOSERS/Annual-Report.aspx>.

² This is due to public pension plans using higher discount rates (the interest rate that pension plans use to translate future liabilities into current dollars) than those recommended by economists. Using a more realistic discount rate, Dr. Andrew Biggs from the American Enterprise Institute calculated that Missouri's five largest pensions had unfunded liabilities FIVE times larger than those officially reported. For more, please read Andrew Biggs, "Public Employee Pensions in Missouri: A Looming Crisis" (Policy Study, Show-Me Institute, 2013), <http://showmeinstitute.org/publications/policy-study/taxes/922-ps36-biggs-public-pensions.html>.

³ Lance Christensen and Adrien Moore, "Pension Reform Handbook: A Starter's Guide for Reformers" (Reason Foundation, July 2014), http://reason.org/files/pension_reform_handbook.pdf.

⁴ Ibid.

⁵ Ibid.

⁶ Rich Danker, "Implementing Defined Contribution Pension Reform: Five Case Studies" (American Principles Project, February 2013), <http://americanprinciplesproject.org/wp-content/uploads/Implementing-Defined-Contribution-Pension-Reform.pdf>.

⁷ Christensen and Moore, "Pension Reform Handbook."

⁸ Ibid.

⁹ Rhode Island Office of the General Treasurer Gina M. Raimondo, "Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System" (June 2011), http://www.law.yale.edu/documents/pdf/cbl/RI_TIN-WEB-06-1-11.pdf.

¹⁰ Anthony Randazzo, "Pension Reform Case Study: Rhode Island" (Policy Study 428, Reason Foundation, January 2014), http://reason.org/files/pension_reform_rhode_island.pdf.

¹¹ Employees' Retirement System of Rhode Island, An Employee's Guide to Understanding the Rhode Island Retirement Security Act, January 2012, https://www.ersri.org/public/documentation/FINAL_RIRSAGuide_January2012.pdf.

¹² Rhode Island Office of the General Treasurer Gina M. Raimondo, "Frequently Asked Questions – Hybrid Plans," <http://www.treasury.ri.gov/secure-pathri/rirsa/faq/hybrid-how.php>.

¹³ Randazzo, "Pension Reform Case Study: Rhode Island."

¹⁴ Institute for Illinois' Fiscal Sustainability at The Civic Federation, "What Are the Rhode Island Pension Reforms?" blog post (April 12, 2012), <http://www.civicfed.org/iifs/blog/what-are-rhode-island-pension-reforms>.

¹⁵ Andrew Koenig, "House Bill No. 485" (Missouri House of Representatives, January 13, 2015), <http://house.mo.gov/billtracking/bills151/billpdf/intro/HB0485I.PDF>.

¹⁶ Committee on Legislative Research-Oversight Division, "Fiscal Note-HB 1682" (March 12, 2014), <http://www.moga.mo.gov/oversight/OVER14/fispdf/5533-01N.ORG.PDF>.

¹⁷ Brad Lee Armstrong and David T. Kausch, "Missouri State Employees' Retirement System Supplemental Actuarial Valuation as of June 30, 2013" (Gabriel Roeder Smith & Company, February 7, 2014), <http://www.jcper.org/CostStatements/statutory/2014%20HB%201682.pdf>.

¹⁸ GASB 68 requires pension plans disclose the net pension liability for a plan using discount rates 1 percentage point above the plan's assumed discount rate and 1 percentage point below the plan's assumed discount rate. Any actuarial report analyzing potential cost savings should use a wider range (especially on the downside) of discount rates when analyzing potential cost savings of a proposed hybrid plan. For more on the GASB rule, see http://www.gasb.org/jsp/GASB/Document_C/GASBDocumentPage?cid=1176160220621&acceptedDisclaimer=true.



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