Written Testimony Concerning SB 338

Committee on Senate KPERS Select

Presented by: Joe Nichols, ASA, MAAA, EA, ACOPA, McCloud & Nichols

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Good Afternoon. My name is Joe Nichols. I am a pension actuary from your neighboring state of Missouri. I want to thank the committee for the opportunity to provide testimony today. In 2011, I was asked to testify before the KPERS Study Commission to discuss retirement plan issues. The goal in my previous testimony was to provide all parties with the most complete information available so that the commission could make very important retirement plan design decisions. At that time, I discussed the pros and cons of defined benefit plans versus defined contribution plans and provided my insight into economic value and risk created by each scenario. I tried not to convey any bias towards one design over another, and I also tried to dispel any simplistic overgeneralizations. For example, if a statement was made that a DC plan eliminates risk, I pointed out that the risk is shifted to the employees, not eliminated. My goal here today is more limited, but I am still hoping to provide information that is helpful in the plan design process. In particular, I would like to discuss an issue that has surfaced regarding the cost of SB 338. Very few people have disputed the fact that, in the long term, assuming an 8% future investment return, SB 338 will create a higher cost than the existing structure created by HB 2194. Once the unfunded actuarial accrued liability is paid off, and all employees are covered under the new benefit structure, the annual cost for the benefits under HB 2194 will be about 0.5% of total payroll in State/school and 0.75% in the Local Group. The annual employer cost after 2032 in SB 338 will be anywhere from 2.5% to 3% of payroll. What has been disputed is how to present the total cost of the bill over the next 50 years. One method presented was a simple addition of each year's excess. While the statement "The total cost of the bill in increased contributions over the next 50 years is ..." is indeed a true statement, it can be misleading. For example, when you hear that someone has won $1 million in a lottery, and then hear that it is payable in $50,000 increments, one does not think – they have a $1 million, at least not someone familiar with economic theory. The immediate thought is that they have won the present value of $50,000 payable over the next 20 years – a value well below $1 million. It is a way for the lottery commission to infer that the winnings are worth more than they really are. Every calculation we do as an actuary includes the time value of money. Bringing streams of payments or costs to one time period is the only way to accurately compare different scenarios. Let me use one more example – If I were to owe you $1,000, a true statement is "I owe you $1,000". However, if I do not have to pay you that $1,000 for 30 years, then I could put $230 into an account, and if I earn 5% per year, will have the $1,000 to pay you in 30 years. So, in today's money, I really owe you $230. Saying that I owe you $1,000 is technically correct, but the information is incomplete and can be considered misleading. Much like my examples, simply stating that the cost of SB 338 is the sum of the annual costs, without stating the present value of the costs, is incomplete. The present value

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will be less than the sum of the additional annual costs, and the present value of the costs is an important piece of information to have for those affected by, and making the decisions.

One other issue that I would like to discuss is the impact of the long term rate of return assumption in determining the increased cost created by SB 338. One of the main reasons for the design of SB 338 was to decrease volatility and dramatically decrease the impact of investment returns on the state's contributions. The drawback of this point is that the employees take on the investment risk, but this point has been thoroughly discussed. The value of the volatility in this bill is difficult to determine with results on only one set of investment return assumptions. For instance, if the long term rate of return actually averages 7% instead of 8%, the long term costs of SB 338 would probably disappear. Conversely, if the long term rate of return actually averages 9%, then the state would eventually be making money in the current design as the employee contribution would be higher than the cost of the benefits. History has shown that it is very unlikely that employees are asked to pay for their entire benefit, let alone pay employee contributions that exceed their benefit. So it seems, that should assets earn less than 8%, the cost savings of the current plan diminish, and eventually become costs. If the assets earn more than 8%, the state's savings increase, but only until either benefits are increased or employee contributions are decreased. The potential downside costs of the current design are not limited but the potential upside savings are. I do not know where the break points are, but receiving projections at 7% and 9% would allow for a deeper analysis of potential future scenarios.

What I have discussed are just two parts of the overall analysis of this bill. However, in both cases, additional information would allow the policy makers to expand their analysis. I think by disclosing additional information, all parties involved will be able to make a more informed decision.