FACT SHEET

South Carolina Policy Council

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10 Reforms for the S.C. Retirement System

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As the S.C. Retirement System Investment Commission meets at Wampee this week, it's our hope the commission is taking a long, hard look at the state's pension plan and considering positive reforms that could make the system more sustainable moving forward.

According to a recent actuarial valuation analysis performed for the state Budget & Control Board, South Carolina's retirement system is carrying a $12 billion unfunded liability. These conclusions are similar to those found by an April 2009 SCPC study ($11 billion in unfunded liabilities as of July 2008), as well as a recent report by the Manhattan Institute for Policy Research. Official projections, based on an 8 percent rate of return, show the S.C. Retirement System (SCRS) is 31 percent underfunded. The Manhattan Institute, using the more conservative projections required of private retirement fund managers, found that the SCRS is 59 percent underfunded.

Retirement System	S.C. Retirement System (SCRS)	Police Officers (PORS)	General Assembly (GARS)	Judges & Solicitors (JSRS)	National Guard (NGRS)	TOTAL
Actuarial Accrued Liability	$35,663,419,000	$4,318,955,000	$69,122,000	$213,406,000	$53,534,000	$40,318,436,000
Actuarial Value of Assets (based on 8 percent return)	$24,699,678,000	$3,363,136,000	$47,189,000	$138,323,000	$17,426,000	$28,265,752,000
Unfunded Actuarial Accrued Liability	**$10,963,741,000**	**$955,819,000**	**$21,933,000**	**$75,083,000**	**$36,108,000**	**$12,052,684,000**
Percentage Underfunded	**30.7%**	**22.1%**	**31.7%**	**35.2%**	**67.4%**	**29.9%**
Number of Active, Inactive and Retired Members	452,380	49,271	580	327	18,993	521,551
Unfunded Actuarial Accrued Liability Per Member	**$24,236**	**$19,399**	**$37,816**	**$229,612**	**$1,901**	**$23,109**

In short, our April 2009 report concluded that South Carolina's retirement system is "significantly underfunded." This liability has several important implications:

> *More spending and higher taxes.* According to Bob Borden, CEO/CIO of the S.C. Retirement System (SCRS), South Carolina's pension plan has historically performed very poorly, "resulting in an excess burden on taxpayers to fund the unfunded liability." Currently, the SCRS is assuming an 8 percent return on investments. Yet the plan produced negative returns of 19 percent for FY2009. Taxpayers will have to – and already are – making up the difference. This is especially true for the National Guard Retirement System (NGRS), the lowest funded public retirement system in South Carolina. From FY2005 through FY2011, lawmakers allocated $22.875 million in General Fund revenue for

the retired National Guard pension plan, which seems to be funded entirely (at least according to the FY2009 SCRS Comprehensive Annual Financial Report) by taxpayers.
Higher credit costs. Pension liabilities are an important factor in calculating credit worthiness and borrowing costs. For instance, Standard & Poor's, one of the big three bond rating agencies, recently cut Chicago's credit rating from AA- to A+. According to Helen Samuelson, an analyst at S&P, a primary reason for the downgrade is that "[the city's unfunded pension liabilities] will place a substantial and increasing burden on its future budgets." Chicago's municipal bonds were demoted from a high grade investment to an upper medium grade investment because of the city's large unfunded pension liabilities. This downgrade will increase borrowing costs. Similarly, if South Carolina's unfunded liability ratio continues to grow, it is likely bond rating agencies will decrease South Carolina's credit ratings – a change that would cost taxpayers millions in higher interest payments.

More risk for retirees. In a worst case scenario, the S.C. Retirement System could default on its obligations. This could mean reducing payments to retirees (not to mention subsequent and lengthy lawsuits in response). Currently, seven states (which also are assuming an unrealistic return on investment of 8 percent) are expected to deplete their pension assets over the next 10 years. Given current assumptions, South Carolina's plan will run dry by 2024, according to a May 2010 paper published by the National Bureau of Economic Research (NBER).

Concludes the NBER report, "There seems to be a high likelihood that future generations will have to bear the substantial burden of making up pension benefits for previous generations of state employees."

Ten Recommendations for Reform

What follows are 10 reforms that would facilitate funding the SCRS at 100 percent, keeping it solvent beyond 2024. The first nine ideas would streamline the existing system and provide for greater transparency. Adopting these reforms would not require a major overhaul of the existing plan. Reform # 10 looks to long-term changes that must be made to sustain the state's retirement system.

1. *Using more realistic investment return assumptions*. In July 2008, the state revised annual investment return assumptions upward from 7.25 percent to 8 percent. Administrators also adopted a 10-year averaging method to estimate asset values. Both of these changes understate potential liabilities – especially in the event of an extended economic downturn. In particular, the 8 percent rate of return permits all five major state retirement accounts to overestimate returns from current employee/employer contributions – and, in turn, continue to claim their plans are funded at 100 percent. If investments don't yield 8 percent – and it is very unlikely they will as based on historical trends – taxpayers will be required to make up the difference. A more realistic assumption would be about 4.5 percent (based on GASB estimates using expected returns from high-quality municipal bonds) to 6 percent (based on actual earnings growth of the S&P 500 over the last 25 years). Likewise, most public funds employ a smoothing period of five years or less.

2. *Implementing a closed amortization period no longer than 15 years*. Taxpayers and lawmakers need an accurate and predictable means of assessing retirement system liabilities. Specific reforms aimed at meeting this goal include reducing the amortization period of unfunded liabilities. Currently, the five state retirement accounts have a remaining amortization period ranging from 16 to 30 years. According to a May 2010 paper issued by the Society of Actuaries, the leading professionals in the modeling and

management of financial risk, this current amortization practice "can lead to perpetual negative amortization in which payments are never sufficient to pay the interest on the [unfunded actuarial accrued liability]." Two changes are needed. First, instead of an open or remaining amortization, the state should adopt a closed and fixed amortization. Second, the amortization period should be shortened to no more than 15 years, perhaps with the aim of achieving a long-term employer cost of 5 percent to 7 percent of payroll.

3. *Prefunding retiree medical liabilities*. The state is currently liable for nearly $9 billion in retiree medical benefit plans. Yet, the S.C. Retiree Health Insurance Trust Funds account is only 3 percent funded. That's another $9 billion in liabilities taxpayers are on the hook for. Clearly, the existing medical benefits program is not financially sustainable. Aside from current/retired members who are already vested or have accrued retiree medical benefits, shouldn't state employees be responsible for paying these costs, instead of shifting the burden to other (in particular, future) taxpayers?

4. *Eliminating TERI*. The Teacher and Employee Retention Incentive Program (TERI) allows state workers to "retire" five years before they actually stop working and then collect a salary even as they accumulate retirement benefits in a tax-deferred account. The fact that state employees can enroll in TERI at a relatively young age (conceivably prior to turning 50) makes this early retirement benefit very generous. The General Assembly came close to eliminating the program in 2010, but the reform was struck out of the budget in conference committee.

5. *Employing independent actuarial analysis*. Including medical benefit liabilities, the state's retirement system liability is at least $21 billion. But additional liabilities – for instance, arising from TERI and the recent recession – are not fully quantified. In particular, current practice treats TERI as a pay-as-you-go program that obscures true costs and does not inform policymakers if there are enough funds to fulfill future obligations. Instead, TERI should be analyzed by an independent accounting firm using actuarial projected accrued liabilities corresponding to reporting standards used in pension and OPEB (Other Post-retirement Employee Benefit) plans.

6. *Eliminating pension COLAs*. Our review of nine major S.C. private sector employers ranging in size from 4,500 to 17,700 employees found that only five sponsored a defined-benefit plan, and none of the plans included cost-of-living increases (COLAs). In the private sector, such provisions are considered unaffordable, and thus even less justifiable in the public sector. At the very least, COLA increases should be eliminated for new retiree program participants. (In spite of legal challenges, some states are also eliminating COLAs for existing participants). Another option is to make COLA increases dependent upon a formula based on the ratio of assets to liabilities.

7. *Requiring more transparency on pension liability at the county/municipal level*. Currently, South Carolina state and local government employee pension plans are aggregated into the S.C. Retirement System – a cost-sharing pension plan. This means local entities are not required to report actuarial information in their financial statements. This practice masks the true liability of each county/city. Each South Carolina governmental entity should report their pension liability using at least as much detail as the state's annual financial statement.

8. *Requiring timely reporting of total pension liability*. Current pension reporting regarding unfunded liabilities seems to be one year behind fiscal year reporting for the state as a whole. For example, South Carolina's FY2009 Comprehensive Annual Financial Statement only includes up to FY2008's

pension information, instead of up to FY2009. Pension obligations should be reported in as timely a manner as possible so policymakers and citizens can make more informed decisions about the state's financial health.

9. *Advocating for better accounting and financial reporting methods*. The Governmental Accounting Standards Board (GASB) is a nongovernmental organization that provides generally accepted accounting principles (GAAP) used by state and local governments. GASB is currently deliberating an overhaul in pension accounting requirements and is expected to issue final statements on pension accounting changes in June 2012. Prior to that – between July and September 2011 – GASB will have an open public comment period on the changes. This means think tanks, governmental officers and activists can use this opportunity to submit their concerns and comments about the pension rule change.

10. S*witching from a defined-benefit pension plan to a defined-contribution pension plan for new employees*. The most fundamental reform the SCRS could make would be to require new employees to switch to a defined-contribution plan (i.e., a 401k) instead of the current defined-benefit plan. Doing so would give public employees more investment choices, but also require them to take responsibility for their own investment decisions. If that sounds like a radical idea, it's how most private sector companies treat retirement benefits. But most private sector companies don't have pension plans supplemented by taxpayer dollars.

More than anything, the state's retirement system should be self-sustaining. This requires funding the SCRS at a 100 percent ratio of assets to accrued liabilities so that pension obligations are fully funded. Currently, the plan seems to be fully funded only because of overly optimistic investment returns that simply will not materialize. As a result, the SCRS is facing insolvency within the next 15 years. Instead of waiting on a bailout from state and federal taxpayers, plan administrators should act now to reform the system and provide more transparency regarding the state's pension obligations.

Nothing in the foregoing should be construed as an attempt to aid or hinder passage of any legislation.

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