

RSA Rebuttal to the API Report on Pension Reform

The Alabama Policy Institute recently issued a report on [Alabama public pension systems](#), focusing on RSA. While praising reform measures that have been adopted, the authors of the report (two Auburn finance professors with no apparent background in pension research), concluded that the pension systems need more reform. The authors recommended adoption of an untested “cash balance plan” as a mandatory Tier III for new hires, but the entire report is premised on erroneous, contradictory and/or flawed assumptions. Below is a synopsis of some of the major faults of the report and its recommendations.

The Report’s Reasons for Additional Reform are Incorrect:

- The authors premise their entire proposal for adopting a “cash balance” pension plan on the erroneous assertion that the primary cause of the pension “shortfall” is the “overly optimistic” 8% assumed rate of return. In fact, RSA’s investments earned an **average annualized return of 11% over the past five years** and over **8% for the past 25 years**, despite encompassing a ten year period with the lowest market returns in the history of the U.S. stock market.
- The report praises the pension reform measures passed in 2011 and 2012 and notes that they will **save the state \$5 billion** over the next 30 years, or an average of about \$162 million per year. The report further notes that the prior reforms will take time to fully recognize the savings because they apply only to future hires. The report nonetheless seeks to replace the current reformed Tier II plan with one that also applies only to new hires and that will **cost the state approximately \$7.8 billion more** over 40 years.
- Ironically, in their examples illustrating why they believe that the proposed cash balance plan should be adopted, the authors **assume an 8% return on investments**. At the same time, the authors argue that the cash balance plan is needed because the pension reforms of 2011 and 2012 were insufficient in that they failed to address the “overly optimistic” 8% assumed rate of investment returns.
- The authors assert that the proposed cash balance plan would greatly reduce the risk of incurring future unfunded pension liabilities, but also assert that the state as the employer would “continue(s) to bear all of the investment risk.” There are **no studies or actuarial analyses** to support the idea that this plan would reduce the risk of additional unfunded liabilities. The structure ensures, however, that **the investment returns will not be available to reduce the current unfunded liability** as they are under the current plan.

The Proposed Cash Balance Plan Would Cost More than the Current System:

- By the authors' own admission, "near-term savings [of their proposed cash balance plan] would be minimal." The proposed plan would at best cost the same as the current Tier II pension plan.
- The only way the proposed plan can maintain the cost of the Tier II plan and provide a comparable benefit (albeit not life-time), however, is to lengthen the unfunded liability amortization period from 30 to 40 years. This would cost the state approximately **\$7.8 billion over 40 years** – an average annual cost of **\$195 million**.
- In order to **provide a benefit comparable to the Tier II plan**, a cash balance plan in which members purchase private annuities **would need 50% more funds** than the current pension plan. For example, if a member earned a Tier II benefit involving a \$200,000 liability, a cash balance plan would need to have \$300,000 to provide an approximately equivalent benefit for the retiree's lifetime.

The Proposed Cash Balance Plan Provides Reduced Benefits:

- Under the authors' own calculations, the proposed cash balance plan would cut benefits for members by **significantly reducing their monthly retirement check** and/or **risking their retirement funds running out** during their or their beneficiary's lifetime.
- The annuity pricing and yield on which the authors rely for their cash balance projections appear to be **unduly optimistic** about the benefits members could expect. For example, the private annuity market can fluctuate and may offer less generous terms than the authors indicate. Thirty year U.S. Treasury yields are currently about 2.5% -- much lower than the 4% yield used for illustration by the authors.

Public Sector Cash Balance Plans are Untested:

- The authors themselves show that only two out of 85 state retirement systems have implemented a cash balance plan. The two plans that have been adopted did not go into effect until January 1, 2014, and January 1, 2015. Eighty of the 85 maintain a defined benefit pension plan.
- The two systems to have implemented cash balance plans are the Kansas Public Employee Retirement System and the Kentucky Retirement Systems (which includes the Kentucky Employees Retirement System). The authors touted the Kentucky plan as a model of reform, but omitted the fact that the Kentucky Employees Retirement System has an actuarial funded ratio of 25.8%, the lowest of any state plan according to a November 2014 study by Milliman. Alabama should pause before reforming its

retirement systems in the same fashion as a state that has managed a retirement system so poorly.

The Report Makes Erroneous Budget and Funding Assertions:

- The authors grossly exaggerate when they assert that 12.1% of the 2015 total state budget will go to pay the TRS and ERS employer contributions. In fact, government estimates are that those contributions will comprise only **7.2% of the budgets**.
- Contrary to the figures in the report, state employer contributions in 2014 made up only **3.46% of the General Fund (GF)** and **7.7 % of the Education Trust Fund (ETF)**. The report inflates the percentages of TRS and ERS employer contributions for FY2006-2015.
- The report is misleading in that it fails to account for the fact that a large portion of employer contributions are paid from federal funds, local funds or earmarked funds. For FY2015, it's estimated that only **65%** of the TRS employer contributions come from the Education Trust Fund (ETF) and only **37%** of the ERS state employer contributions come from the General Fund (GF).
- The authors complain that RSA's unfunded liability has "skyrocketed" over the past 10 years, and while they acknowledge that this period included the "worst recession since the Great Depression," they omit the fact that a substantial part of this increase is due to **unfunded cost-of-living adjustments ("COLAs")**.

Conclusion

The inaccuracies and unproven theories in the report reflect a lack of understanding of pension funding and administration, undermine the report's credibility, and caution strongly against its proposal to overhaul Alabama's retirement systems in a radical and fundamental manner that could have lasting and detrimental consequences for both the state and public employees.