NDPERS Comments on Draft Defined Contribution Legislation
September 10, 2014

Mr. Chairman, members of the Committee my name is Sparb Collins and I am the Executive Director of the North Dakota Public Employees Retirement System (PERS). I have had the opportunity to review the bill drafts relating to PERS and its funding (LC 176, LC 189 & LC 010) with the NDPERS Board and they would offer the following comments for your consideration (also noted is the bill they apply to):

1. Funding of the Shortfall Created by the DC plan (LC 176; LC 189: LC 010)
2. Integrity of the Trust (LC 176; LC 189)
3. Investments/Returns (LC 176; LC 189)
4. Pension Adequacy (LC 176)
5. Ancillary Benefits (LC 176)
6. Governmental Accounting Standard Board (GASB) Requirements (LC 176)
7. Contributions (LC 176)
8. Long Term Costs (LC 176)
9. Eligibility and Transfer Provisions (LC 176)
10. Contract Issues relating to Political Subdivisions (LC 176)
11. Technical and Actuarial Review (LC 176; LC 189: LC 010)

1. Funding of the Shortfall

As a result of your study to date, we have learned that the PERS Main Retirement Plan will become insolvent at the existing contribution level if a defined contribution plan is passed that requires all new employees to join it effective January 1, 2016. This has been confirmed by both Segal and Gallagher. The bill before you today goes one step further than the concept used to determine the above in that it will allow all existing defined benefit members the opportunity to transfer to the defined contribution plan. This has not been reviewed by either Segal or Gallagher, so we do not know how that would affect the plan. This needs to be determined to know the shortfall amount. Based on past experience this could range from no cost to almost doubling the cost. I will discuss this in more detail in number 8.

Secondly, the proposed actions in the bill drafts before you today would put the retirement plan on a path to insolvency before a funding plan is approved. Specifically, it appears that the effect of the three bills is to close the plan to new participants by January 1, 2016, which will put it on a course to bankruptcy. To offset this funding shortfall, monies could come from the Foundation Aid Stabilization Fund if a constitutional amendment is adopted by the voters and if the money is transferred by a future legislative session (2017 or later). What if it is not adopted? A huge unfunded liability will have been created with no funding mechanism. The 2017 session would have a crisis to address. The state's financial statements would be affected and if this is applied to political subdivisions, theirs would be affected as well. We know from your study, and based upon the information from Segal, that this would create a funding deficit of $3,688,100,000 that would have to be paid on a pay as you go basis from the general fund unless an alternative retirement funding plan could be developed and implemented by a future legislature. If this was paid on a pay as you go basis instead of some of it coming from investment earnings, it would potentially come directly from the general fund, a dramatic cost shift to a single funding source.

The PERS Board suggests that no bill should be implemented until a clear funding plan is adopted that gets the plan to 100% funded status, covers all costs and provides retirement security to all members. The DC bill should have a contingent effective date until a clear plan is adopted that stops the downward trend and puts the retirement fund on track to 100%.

2. **Integrity of the Trust**

The retirement fund is established under North Dakota State law and Federal law as a separate trust fund for the exclusive benefit of the members and managed according to the prudent person rule. The concern with these bills is that retirement monies would potentially be held in a Retirement Stabilization account that is not part of the retirement trust. So what does this all mean and why is it important? Keeping retirement money in the retirement trust is important since it means the money is set aside for retirement and is protected from claims by creditors of the employer, that the money is managed by trustees whose sole responsibility is the benefit programs they administer, and the funds cannot be diverted for other uses. The importance of having it in a retirement trust is that when held in a non-retirement account, the retirement plan members do not have any ownership in the account or its assets which could be diverted for uses beyond solving PERS funding problems created due to closing the defined benefit plan. The importance of having all funds managed by retirement trustees is that retirement trustees are subject to an extensive and stringent set of fiduciary obligations to insure the integrity of retirement plan assets, whereas non-retirement trustees may have broader ranging responsibilities that may at times be in conflict with that of the retirement plan. While these wider ranging set of interests could be well intentioned, they may not be consistent with the needs of the retirement plan. The wider set of interests could include such things as Economically Targeted Investing and social investing. When there is a conflict, what interest is to be represented when someone is not responsible for the exclusive benefit to the members of the retirement fund? This also is not consistent with general methods of managing retirement assets. Holding money in a separate account would not pass the ERISA test in the private sector since funding of the trust is not clear (ERISA does not apply to government). Consequently North Dakota could be doing something that would not be allowed in the private sector. In the governmental sector, the closest example of holding funds in a non-retirement fund is the 457 plan assets. Prior to the mid 90's these funds were a general asset of the employer. In the mid 90's several local governments faced bankruptcy and these funds were at risk to the creditors of the employer. This so shocked the public that Congress passed a change to the federal law that put these funds in a trust for the exclusive benefit of the members. What these situations point out is the importance of retirement funds being held in a trust, for which the sole purpose of its existence is to meet the needs of its members. It also points out that holding money in a separate fund that may be required to meet a broader range of needs raises many concerns and would provide less security instead of more to members.

The PERS Board suggests that PERS retirement funds should be held in the retirement trust for the exclusive benefit of the members and these bills should provide for such safeguards.

3. Investments/Returns

The Board offer's the following three comments/suggestions in this area.

First, concerning the rate of return, the Board is concerned that the existing proposed method may not allow for that to be achieved. Funds are proposed to be deposited in the Retirement Stabilization Account. Those funds would likely be put into the general fund until the legislature would potentially authorize a distribution to PERS. While in that account, the funds would earn a short term rate of return which today is below the 8%. The calculations provided to you to date assume the money would earn 8% from the point in time identified. This method would limit that to a lower percent until funds are deposited into the retirement fund which will substantially increase the cost and that has not been considered.

If this method is to be used, the PERS Board suggests a much lower rate of return should be used in developing the calculations necessary to fund the retirement plan.

Second, even if the above was modified to allow the funds to be invested across asset classes to get a return of 8%, depositing them in the Retirement Stabilization Fund instead of directly into the retirement fund could still leave them outside the existing retirement investment management process. If the same level of diversification and risk reduction were to be accomplished, having the funds in the Retirement Stabilization Fund could increase investment costs which are the single highest cost of program administration. This is something both the PERS Board and TFFR Board recognized in the late 1980's when the two boards came to you to reorganize the state retirement investment process. Specifically, proposed at that time was establishing a mechanism to allow comingling of retirement assets for investment purposes under the State Investment Board. The reason the proposed method was more cost effective is that the more money that you can invest with a single manager, the lower the cost. When you allowed for the reorganization of investment management, you allowed the funds to be co-mingled so there was one contract relationship which reduces overall investment costs. However, if money is to be held in a non-retirement fund with the same level of diversification, this co-mingling could not occur since the other fund would not be a retirement fund. Consequently, investment costs could rise.

The PERS Board suggests that this be carefully studied to make sure the same level of diversification could occur without increasing investment costs.

Third, if the Hybrid/DB plan is closed, it will become like a DC plan with a limited investment horizon. That means the ability to sustain the asset allocation we have today, which should generate 8%, may not be reasonable. Instead, it may need to be replaced with an asset allocation that, like a DC plan, would have a glide path to a more conservative asset allocation over time. This means that an 8% long term return assumption may be too aggressive and it may have to be lowered. If it was lowered just 1% less (8% to 7%), it would alter the Segal one time payment amount of 162.8 million to 448.2 million. If 2% less it would alter it to 803.1 million. In order to have a clear understanding of the real closing cost we need to have an accurate return assumption based upon the plan closing since we believe that the existing asset allocation for an open plan cannot be sustained in a closed plan.

The PERS Board suggests that an investment consultant review and develop a reasonable asset allocation over time and determine what that return would be so an accurate assumption can be used to determine the closing costs.

4. **Pension Adequacy**

At a previous meeting we discussed that the existing level of benefits provided by the Defined Contribution fund has not been historically adequate nor do we believe it is presently adequate. We reviewed the Segal study which showed a funding shortfall for the DC plan. We also discussed that as a result, 75% of the existing members feel they made a mistake by transferring to the defined contribution plan, 69% would not recommend it, and over 70% are not confident that they will have enough money to retire on. In addition, we noted that the DC plan does not seem to be very attractive to new members. If the state is to move to a defined contribution plan, a study needs to be conducted to determine what level of contributions would provide an adequate pension plan. The existing plan does not seem to be accomplishing that.

The PERS Board has been concerned with the pension adequacy of this plan for many years. That is why the DC plan has been a part of the recovery plan PERS proposed in 2011. At that time, we proposed increasing the contributions to this plan to 16.12% with a 2% increase in 2012, 2% in 2013, 2% in 2014 and 2% in 2015. To date, the legislature has approved the 2012, 2013 and 2014 increases. As a result of our continued concern, we have submitted a bill to the Legislative Employee Benefits Committee for the last 2% increase to be considered by the upcoming legislature.

If this is to be the mandated plan for new employees in the future, the PERS Board suggests it should provide an adequate pension benefit at a similar level as benefits in the existing defined benefit plan.

5. **Ancillary Benefits**

At the last meeting we noted that some ancillary benefits of the DB plan, relating to disability and spousal benefits are not provided in the DC plan. We note that this bill does not address this disparity in benefits. You may want to study adding these provisions to this bill so it will not result in a benefit inequity to the members who would be required to join the plan. One method to accomplish this would be to set up a long term disability policy for each employee in the DC plan and increase the employer paid life insurance benefit to provide for the spouse.

The PERS board suggests that if the DC plan is to be the primary retirement plan, consideration should be given to these ancillary benefits.

6. **Governmental Accounting Standards Board (GASB)**

Several meetings ago we talked about the new Governmental Accounting Standards Board disclosure requirements for pension plans. The effect this bill will have on those requirements should be studied closely since it could increase the unfunded liabilities on the financial statements and that could influence our overall financial ratings. The various rating agencies have recently made public statements equating management of pension liabilities to management of debt. If the State does not conservatively manage either, the State's bond rating may suffer, causing additional unknown interest costs. The PERS Board does not know the answer to this if the bill is passed. But we do know that the increased disclosure requirements will make pension funding status more apparent to users of the State's financial statements. We also know from our previous discussion that if a retirement fund is not adequately funded, the GASB requires that a lower discount rate be used to value the liability, thereby increasing the long-term pension liability of the State. We also believe that funds in the Retirement Stabilization Fund may not count toward plan funding for purposes of the State's financial reports in accordance with GASB standards as funds are not irrevocably deposited with the various plans. The example that Segal showed is that the present PERS liability for the entire main plan with an 8% discount rate is about $734 million at market value ($412 million for the state only). But if we were required to use a 7% rate, the PERS liability would increase to just over $1 billion - a 43% increase. The PERS liability would be even higher if the State were required to use a 6% or 5% rate. In order to assure that this does not happen this bill should be studied or the law should provide that it could be suspended by some entity should it cause the financial position of the state or participating employers to erode.

The PERS Board would suggest that this be carefully studied so the proper funding plan is implemented to appropriately manage these liabilities so they are reflected on the financial statements in the way the state would want and so the state has a clear understanding of the implications of any change instead of having to react to it after the fact.

7. **Contributions**

To date, the Legislature has approved 3 years of the 4 year recovery plan for PERS. This recovery plan is shared between the employer and employee with ½ being paid by each party. We told PERS members that if they contributed to this effort it would stop the downward trend in the funded status of the plan and put it on a course to 100%. The employees have stepped up and paid their share and at this point it totals 3% of salary with the last 1% being proposed for your consideration next session. If this bill (LC 176) passes, it would again put the plan on track to insolvency or 0% funded status unless the constitutional amendment is passed and if future legislatures immediately start depositing money in the trust fund to reverse that trend. Clearly this bill will change the understanding with employees. This could cause members to reconsider their commitment of contributing to the plan. While it is hard to determine the implications of such reconsideration, one result could be a lawsuit by aggrieved members. As we have previously noted, there is a risk that a court could find such contribution requirements a violation of the contract for existing employees possibly resulting in a loss of the employee contributions thereby increasing the employer requirements. While this is a remote risk it needs to be recognized.

The PERS Board believes that employees need to be assured that their contributions, funds and benefits are protected and they are contributing to a plan that will be 100% funded. To accomplish this and to insure employees' money is being protected, we would suggest that wording be added to the bill that would allow the PERS Board to set the employer contribution rate based upon the funding

requirements of the plan as determined in the actuarial report. The Legislature has granted the Board this authority for the National Guard Plan and the Law Enforcement Plan.

The effect of this would be that, if the DC bill is passed and the other funding bill is not, the Board would likely have to increase employer contributions by about 23% to 26% depending on whether the goal is to pay off the unfunded liability in 20 or 30 years. The state employer contribution is presently 7.12%, and with the employee pick-up in the early 80's in lieu of salary increases, the state presently pays a total of 11.12%. This would increase the state payment rate from 11.12% to about 35% (based upon Segal projections).

8. Eligibility and Transfer Provisions

In this area the Board has two thoughts to share. The first is relating to who is eligible under the bill and the second is concerning the transfer provision.

First, this bill expands the eligibility for the DC plan to existing members of the DB/Hybrid Plan. Also, as discussed above, this has not yet been factored into the cost to date. One variable in determining the cost would be predicting how many would elect to transfer. The plan was originally offered in 1999. We had Segal do a look back in 2000 on the cost to the plan of offering the transfer option. In the Main System it did not change the cost to the plan, because it was only offered to non-classified employees, which is a small percent of the total group (in 1999 this was approximately 610 eligibles out of 16,000 active members). Of the approximately 610 who were eligible for the DC plan, 235 or about 39% elected to transfer out of the DB plan which had little impact on the overall plan. By contrast, in the National Guard Plan the whole group was eligible and 56% elected to transfer. This increased the actuarially required rate substantially; in fact, it just about doubled the employer rate from 3.84% to 7.29%. This option was also offered in 2001 to state non-classified employees and by then the investment environment had changed, and out of 421 eligible, only 4, or about 1% took the option to transfer.

Consequently, the Board suggests that the cost of allowing the option for existing employees to transfer be determined before any bill is passed so it is clearly understood what it does to the funding requirements.

The second area is the transfer method. The bill before you changes the previous offering in that it only offers the employee the opportunity to transfer their contributions plus interest. Previously, it was based upon the higher of contributions plus interest or the net present value (NPV). Based upon our previous experience we note:

1. For members identified as being eligible to transfer from DB to DC, the following is the number for which the net present value calculation was higher than the actual contributions + interest;

   1999 – 235 out of 610 (39%)

   2001 – 142 out of 412 (34%)

2. For members who actually elected to transfer, the following were NPV vs. actual contributions + interest;

   1999 – 23 NPV and 216 Contributions + Interest

   2001 – 0 NPV and 4 Contributions + Interest

As the above shows, limiting it to contributions plus interest is to the disadvantage of some employees. Our information shows the years of service for those where NPV calculation was higher was 16 years; whereas for those using the other method, the average was 5.6 years. Therefore, this could mean that not including the NPV calculation option is to the disadvantage of long term employees.

Concerning using the contribution plus interest method, we know that for us to compute these numbers is a very time intensive effort since a determination needs to be made for each member. We are researching the average time that would be necessary per member, but if it was ½ hour per member, then for 10,000 members it would be 5,000 hours or 30 months of effort. In 1991 this was done for about 600 members and we hired temporary staff to assist; however, this time it would be for 10,000 members. This could require us to hire 2-3 temp staff for about 1 year which would require an appropriation to be added to the bill. The NPV method is much easier, but if you reverse the above numbers you see a disadvantage to the majority of employees with shorter terms of employment. Other methods such as using the employee account balance to pro-rate could be much more efficient in terms of time, but we need to determine the equity of such a method through a study.

The PERS Board suggests that a study should be done to determine if a more reasonable method could be used that could provide an equivalent outcome with less administrative cost.

9. **Long Term Cost**

It has been reported to you that once the unfunded liability of the Hybrid/DB plan is paid off, the contribution level can be decreased to the normal cost which today would be a total of 10.31% of payroll. If the DC contribution level is set at 12.12%, or the current rate of 14.12% or the 16.12% PERS is proposing, then the long term cost of the DC plan after the unfunded liability is paid is the difference. Specifically, the long term cost of the DC plan could be anywhere from about 1.8% to about 5.8% higher on future payrolls. These are substantial cost differences on future payrolls for participating employers if accurate.

The PERS Board suggests that a study be done on the long term cost to the employer.

10. **Contract Issues Relating to Political Subdivisions.**

As discussed at the last meeting, Political Subdivisions can join the PERS plan under state statute if they so elect by signing a contract with PERS. Before any consideration is given to closing the plan to political subdivisions, the effect of these contracts should be determined.

The PERS Board suggests that before any legislation relating to political subdivisions is considered, any contract limitations should be identified so they do not arise in implementation.

11. **Technical and Actuarial Review**

In recognition of the above, the PERS Board would support having a detailed Technical and Actuarial review of the proposed bills. This review could incorporate a study of the above issues as well as identify and resolve any other issues. Whatever course is decided, the Board believes that a full actuarial review is necessary to understand and recognize the various implications to the plan because this is the primary retirement plan for about 21,000 active members and 8,000 retirees. The decisions made here will have a direct effect on many lives and could have a significant financial effect on our participating employers.

Also attached for your information are some specific comments on the bill that I will leave with you for review. I would be available to answer any questions on those whenever you would like.

In conclusion, the PERS Board recognizes that it is a policy decision for you on whether to continue to offer the DB/Hybrid plan or just a DC plan. However, the Board notes that there are substantial costs, funding and procedural issues that need to be resolved and if they are not addressed, all the funding progress of the plan to date would be lost and instead it could create a plan with substantial liabilities which could affect the financial status of the state and possibly its political subdivisions. The Board would suggest that:

1. A clear funding plan should be established to get the plan back to 100%.
2. The integrity of the trust should be maintained.
3. Investments/Rate of Return should be studied so accurate assumptions and methodologies are put into place.
4. Any new pension plan should provide for an adequate benefit equal to the existing plan.
5. Consideration should be given to the ancillary benefits.
6. Nothing should be passed that causes the GASB liabilities to increase.
7. Contribution authority for employer contributions should be given to the Board in order to insure a stable plan.
8. The transfer methods should be studied.
9. Long term costs should be studied and determined.
10. Contract Issues relating to Political Subdivisions should be identified before any legislation is considered.
11. A detailed technical and actuarial review should be done.

Thank you for providing the PERS Board the opportunity to share its thoughts with you today.