

## FINTestimony

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**From:** mailinglist@capitol.hawaii.gov  
**ent:** Friday, February 25, 2011 9:19 AM  
**To:** FINTestimony  
**Cc:** swartzg001@hawaii.rr.com  
**Subject:** Testimony for HB1037 on 2/25/2011 10:00:00 AM

**LATE TESTIMONY**

Testimony for FIN 2/25/2011 10:00:00 AM HB1037

Conference room: 308  
Testifier position: support  
Testifier will be present: No  
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Submitted on: 2/25/2011

**Comments:**

I support this bill to the extent that it attempts to increase funding for the underfunded ERS Pension Fund. However, the contribution percentages need to be increased further to prevent the looming failure of the Fund.

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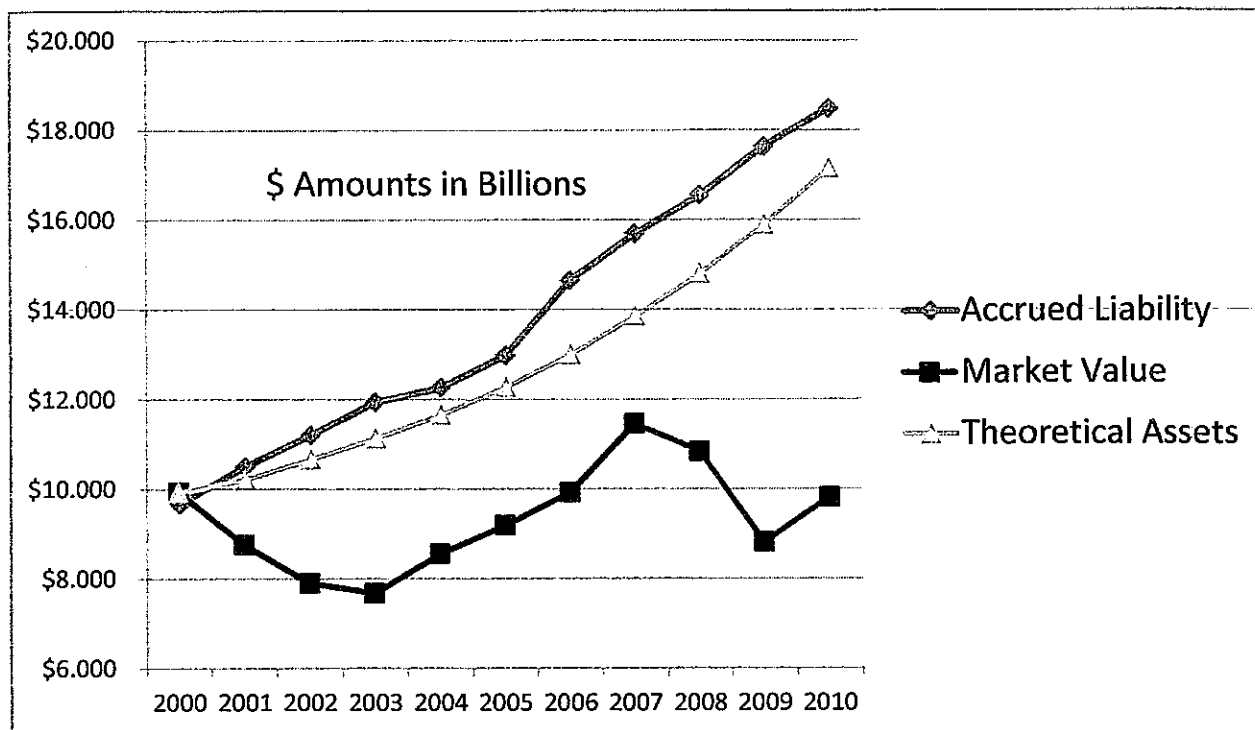
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HB1037

GEORGE L BEARISH

**LATE TESTIMONY**

## State Of Hawaii Government Employees' Retirement System Funding



**Actuarial Accrued Liability:** Amount taxpayers owe for retirement benefits earned to date by government workers under HRS, Chapter 88 (Guaranteed by taxpayer's full faith and credit).

**Earmarked Public Assets' Market Value:** Public assets transferred from State and County General Accounts to a special fund dedicated to paying off the taxpayers' actuarial accrued liability when the underlying retirement benefits become due for payment in the future.

**Theoretical Value of Public Assets:** The value earmarked public assets would have had if the retirement system board earned an 8% average rate of investment return. (The actuary engaged on behalf of government workers states legislators directed him to "assume" 8% when making the estimates legislators rely on when making decisions affecting the retirement system.

**Red-Blue Gap:** The amount public assets to date fall short of the amount taxpayers owe government workers for retirement benefits they have earned to date. No shortfall existed as of June 30, 2000. In fact the system was 103% fully funded. In the ten subsequent years the shortfall grew to almost \$9 billion as of June 30, 2010 (underfunded).

**Green-Blue Gap:** The amount of shortfall directly attributable to legislative contribution decisions and normal failure of the actuary's assumptions to perfectly predict future events.

**Red-Green Gap:** The amount of shortfall attributable to retirement system board investment decisions. Earmarked assets whose investment they direct, earned a 10-year average return of less than 3%, and even their pre-Fannie Mae (2000-2008) 8-year return of less than 5% -- while the actuarial estimates on which legislators have relied "assumed" it would be 8%.

see also:

<http://www.civilbeat.com/articles/2011/02/17/9023-a-way-to-save-hawaiis-government-employees-retirement-system/>

# CIVIL BEAT

Thursday, February 24th

## A Way To Save Hawaii's Government Employees' Retirement System

By George Berish 02/24/2011

**Editor's Note:** This is the final article in a series on Hawaii's retirement system. You can find definitions of terms used in this story [here](#).

- Part 1: [A Danger Demanding Sunshine](#)
- Part 2: [The Consequences of Hawaii's Public Pension Shortfall](#)
- Part 3: [The Why and What of Retirement Systems](#)

The first three articles of this series laid a foundation for understanding Hawaii's Government Employees' Retirement System (HERS). So here we are, with the HERS fund almost \$9 billion short of the system's accrued actuarial liability ("AAL"), which is taxpayers' liability for government worker retirement benefits earned to date. (This underfunding is as of June 30, 2010, the latest figures available). Ten years ago the fund equaled 103 percent of the AAL (overfunded). And yet we, and the lawmakers who represent us, have been kept so uninformed, and therefore so unconcerned, no changes have been made to stop the deterioration.

In fact, effective 2005, Hawaii's lawmakers, Gov. Linda Lingle and the HERS board amended the governing law (PL-88) to eliminate the 80-year-old requirement that annual transfers to the HERS fund be calculated using an accepted actuarial cost method. They replaced that requirement with a lower amount set by government fiat. That violated the theory underlying the system's original design. It also made an already obscure system totally opaque, hid the problem from themselves and us, and it ignored the real problem that continued to add several billions more debt. Since then, they've increased the fiat amount when necessary to meet the requirements of Government Accounting Standard No. 25, because failure to meet that standard would likely reduce Hawaii's bond ratings. That includes today's HB1037, which just throws another \$100 million of tax revenues Hawaii's deficit budgets don't have, and taxpayers can't afford, at the problem. Otherwise no changes have been proposed to eliminate the causes of the deterioration.

So are there any solutions? Yes. There are two

Do nothing. Keep throwing money we don't have at the problem, till it runs out. Then investors and bond raters will raise the interest rates on Hawaii bonds till we have no option but scrapping the current "definitely determinable benefit" plan and put government workers into an "individual account plan" like the ones offered by a majority of non-government employers and an increasing number of government employers.

I know Hawaii's Constitution says: "Membership in any employees' retirement system of the State or any political subdivision thereof shall be a contractual relationship, the accrued benefits of which shall not be diminished or impaired."

For reasons I can't imagine, the union claims "accrued benefit" means "all the benefits an employee can ever earn in the future under the plan that existed when she or he was hired", so current workers "who have theirs" believe they don't have a dog in this fight. However, with much experience as an expert in legal proceedings related to retirement benefits I know that without exception, the term "accrued benefit" is interpreted by the actuarial profession, accounting profession (GASB and FASB), federal benefit and tax laws, and plain English, to mean "benefits earned to date". So I can't think of any argument, short of raw political power, that could support the unions' illogical assertion that the rest of the universe is wrong. Can you?

But even if raw political power is enough in Hawaii, here's something current workers should remember: From today forward your numbers will shrink, and the number of future workers will grow. Therefore, someday not so far away, future workers will outvote current workers when negotiations require choosing whether to spend

available dollars to increase current wages or to maintain your totally unfunded, unguaranteed retiree medical benefits. You will lose that vote tomorrow if today you insist on sticking future employees with inferior benefits. And that is regardless whether it's an "individual account" plan or one more 2nd class "tier" of the current "definitely determinable benefits" plan. Note: Today government workers doing the same job get more or less valuable tiers just because they have different hire dates, e.g. they get the contributory plan, non-contributory plan, hybrid plan, or in the future a still less valuable level 4th tier being recommended by the HERS chair. Anything that splits government workers that way is a bad idea.

The other solution is to modify the current system design in a way that will keep the cost of its "definitely determinable benefits" as orderly and predictable as those of an "individual account" plan. And accomplishing that is the only way I know to prevent investors from adding an interest premium the state can't afford to Hawaii's bonds for the luxury of keeping the government workers' "definitely determinable benefits" plan.

So here's a solution that, based on 30 years of experience as a Fellow of the Society of actuaries, I know will work. It is a set followed by the facts and reasoning that led to each of the components:

- **Retain the HERS office as is:** The inherent complexity of negotiated plans that provide "definitely determinable benefits" to multiple government employers requires a specialize staff separate from the employer's personnel office.
- **Reduce HERS board power:** Retain current makeup, but strictly limit its duties and authority to oversight of the HERS office. That includes, overseeing the faithful calculation of eligibility for, and the amount of, benefits promised by PL-88, in strict compliance with its provisions, and certifying them for payment. Also responding to government worker requests for information, helping them understand their very complex benefits, applying for them, and receiving a fair review when disagreements arise.
- **Create a Public Asset Investment Board:** Establish a new outside board, appointed by the Governor, approved by the lawmakers, with eligibility criteria set by law that require all members to have significant, successful experience related to the prudent management of \$10 billion dollar investment funds — especially in managing of investment risk level.
- **Reassign control of professional advisers:** Today the HERS board has exclusive authority to engage the actuary, auditor and outside legal counsel. And the public's representatives — elected officials — must rely on them in negotiations and when investigating problems, even though the board publicly declares it has an exclusive fiduciary duty to government workers that affirmatively prohibits it from considering the general public's or taxpayers' interests.

Leave Auditors and Attorneys assigned to the HERS board. The board's remaining duties demand such support.

Reassign the actuary to elected officials. The actuary's primary role is related to funding of retirement benefits, and since those benefits are guaranteed by public's full faith and credit the public, and especially taxpayers, have exclusive responsibility for managing that funding. Therefore the actuary should report to their representatives who are our lawmakers.

Reassign Investment Consultants and Investment Managers to the new Public Asset Investment Board. This seems self-evident, especially when the public bears 100 percent of the investment risk, while government workers bear 0 percent.

- **Require the actuary to certify that "actuarial assumptions", taken as a whole, represent the actuary's "best estimate":** That is universally required of actuaries who service plans of non-government employers, but not of the HERS actuary. For example, the most powerful "assumption" is that the HERS fund will earn an average investment return of 8 percent, yet the actuary's report says it is "Set by the legislature" (I suspect that will come as a surprise to most lawmakers who cannot be blamed if they assumed it was recommended by the actuary — or at the very minimum the endorsed by the actuary).
- **Correct Hawaii's gross misinterpretation of the term "Accrued Benefit" in its Constitution:** Government worker unions interpret "accrued benefit" to mean all the benefits an individual can ever earn in all future years based on the plan in place when she or he was hired. However, general English usage, a hundred years of actuarial writings, literally hundreds of thousands of pages of federal committee reports, law (Employee Retirement Income Security Act of 1976), regulations and IRS publications; and all FASB and GASB accounting standards relevant to "definitely determinable benefits", universally interpret "accrued benefit" to mean the benefit earned "to date". As discussed below, adopting the universal interpretation is the key to any rational solution.

By way of further explanation, here's why I believe a failure to act decisively with the above modifications, will result in future employees being forced into an "individual account plan" (and possibly all employees if the economy stays bad enough to rationalize today's illogical interpretation of "accrued benefit"): Investors hate uncertainty and charge dearly for it. And they know:

- Government employers with plans based on "individual accounts" are never underfunded, and when they project that the cost of currently negotiated benefits is 10 percent, that is what investors will see until, and unless, the plan is changed in future bargaining negotiations – Zero Uncertainty.
- Government employers with "definitely determinable benefits" can grow billions of underfunding with no plan change at all, and there's no guarantee next year's cost will bear any rational relationship to the projections given to investors — Limitless Uncertainty.

Just look at investors who bought Hawaii bonds in 2000. They were told retirement benefits were fully funded, and the "normal" annual cost was around 6 percent of payroll. Since then, with no material plan changes, fully funded became almost \$9 billion underfunded, the 6 percent more than doubled in 5 years, and now HB1037 proposes increasing it lots more. Then last week the HERS chair tells a newspaper HB 1037's 25 percent should have been 28.5 percent.

Or look at the June 30, 2010 actuarial valuation report in which the actuary casually writes the system's funding is no longer adequate to meet Government Accounting Standard 25 (bullet 6, page 6), PL-88 requires the annual transfer amount be adjusted, and the HERS board should ask for more than is needed today to avoid having to go back for more in future years (paragraph 3, page 2).

Therefore, the provisions recommended above are intended to persuade investors Hawaii can fund our "definitely determinable benefits" with a certainty comparable to that automatically imposed by an "individual account plan". And I believe failure to do that will drive the interest premium that investors demand of Hawaii to unaffordable levels.

If that were to occur, the money to pay that increased interest premium would have to be taken from already staggering taxpayers and/or stolen from other public expenditures that are already being cut back, e.g. schools, homeless, police and fire protection, green initiatives, health care, etc.

So while government workers may be more politically powerful than any other group in Hawaii, I doubt they will be more powerful than the combination of all the groups that will have to pay dearly to keep government workers' "definitely determinable benefits". Of special concern is that people in those other groups don't have the benefit of plans that provide "definitely determinable benefits", so having government workers join them in an "individual account plan" to protect every other budget line would seem fair.

In conclusion, I welcome anyone who would like to discuss and better understand my recommended changes joining me on the [discussion page](#) Civil Beat set up for this topic where I will try to answer serious questions. Otherwise the remainder of this article sets out the facts, and reasoning that underlie my recommendations.

- One reason I recommended separate administration and investment boards is that PL-88 specifies the HERS board's members must be: a retired government worker, a public school teacher, two union officials, three political appointees (one a local bank executive) and the Director of Finance, ex officio. That composition is perfect for overseeing the administration of government worker benefits. But it seems self-evident that no \$10 billion Investment Fund would appoint such a board to pick, and supervise the fund's investment managers; and maintain the fund's risk at a level prudently consistent with its investor's ability to take risk.
- Almost all of today's shortfall results from the HERS board averaging less than 3 percent during the last decade, while all negotiations, and other funding decisions, were based on actuarial calculations that "assumed" the HERS board would average 8 percent. But it's unfair to criticize them, because they weren't all selected for their investment education, training, or experience.

Note: When cost estimates "assumed" 8 percent, but only 3 percent is earned, it means the estimates hugely underestimate the ultimate cost.

- The second reason I recommended separate administration and investment boards is to eliminate the awful conflict of interest created when a single HERS board controls both functions. The board declares it has an exclusive fiduciary duty to government worker interests, and that means it has an affirmative obligation to ignore the public's and taxpayers' interests. Yet the public bears all risk arising from the HERS board's investment decisions, because government worker benefits are guaranteed by the public's, especially taxpayers, full faith and credit – not the HERS fund, i.e. the public bears 100 percent of the risk and workers 0 percent.
- I recommend reassigning the actuary to control by the lawmakers, because the actuary's professional area of expertise is the prudent funding of plans that provide "definitely determinable benefits", and the party that has sole and total responsibility for prudent funding is the public as represented by lawmakers. That makes leaving control of the actuary with the HERS board whose exclusive fiduciary duty is to government workers an obvious conflict of interest. In addition, the union already engages an independent actuary to help it pursue government worker interests in negotiations. This reassignment would fairly balance public and worker interests by providing equally independent advice to lawmakers.
- I recommended a "best estimate" requirement for the same reason federal law requires it of non-government employer plan actuaries. That requirement denies the actuary — who uniquely understands the consequences of "assumptions" — the luxury of ignoring obvious problems she or he is uniquely qualified to prevent, i.e. the actuary cannot justifiably claim her or his role is legally limited to just following orders. More specifically, I doubt the HERS board actuary would have continued to use 8 percent for so long after it was clear 8 percent wasn't being earned if his firm wasn't legally allowed to disavow any responsibility for that "actuarial assumption" by declaring it was "Set by the legislature".
- Finally I recommended Hawaii adopt the universally recognized interpretation of "accrued benefit", because I can't overstate the danger posed by the current uniquely illogical definition.
  - Hawaii's unique definition has already forced Hawaii to create several different classes of workers, i.e. today "other" government workers doing the same job are given different unequally valuable plans: a contributory plan, non-contributory plan, and hybrid plan. And the current HERS chair is recommending a 4th tier of even less valuable benefits.
  - I believe it's ethically wrong to pay workers doing the same job different amounts just because one was hired a day earlier than the other. And as an actuary I know that failure to maintain fairness in any multi-generational collectively funded enterprise leads to its collapse for all. So current workers should remember their retirement medical benefits are 0 percent funded, have no "accrued benefit" Constitutional protection, and make no specific promises concerning covered services, deductibles, copayments, etc. So someday, they will need future workers who are willing to take less in wages to maintain the quality of the retiree plans now in place.
  - Adding another tier does nothing to address the primary cause of today's almost \$9 billion deterioration, which is the HERS board's decadelong failure to earn the 8 percent "assumed" by prior actuarial cost estimates that were used to negotiate the current benefits.
  - All negotiations require the actuary to estimate the cost of requested benefits. Obviously such estimates in past years massively underestimated the cost of today's benefits when they were given away, i.e. no estimate predicted today's billions of underfunding and 28.5 percent of payroll costs. Now the union's unique interpretation of "accrued benefit" requires any negotiated correction to those unintentional errors be limited to the benefits of future workers who didn't benefit from the mistakes. And that makes it impossible to rationally negotiate modest changes shared by all. I know sticking future workers with inferior benefits is temptingly easy — today — because they aren't here yet to complain. However, it requires huge, even unconscionable, cuts to future worker benefits. That's because to have any effect today, the losses produced by many current workers



must be recovered from cuts made to benefits of future workers whose numbers will remain small for many years.

- Multiple tiers in a system that already has multiple plans (police & fire, and other) that cover multiple employers makes it impossible to understand, and impossibly difficult to administer. Just read PL-88 today and imagine adding another tier to it. Or see pages 47-52 of the actuarial valuation report for a "brief" 6-page summary.
- Please note carefully: The universal definition of "accrued benefits" still prohibits reduction of benefits once they are earned. It prohibits any change at all to retiree benefits. For current workers with say 20 years of service, it prohibits any change to benefits that have been earned in those 20 years. It only permits changes that affect the amount earned for service after any renegotiation. Most importantly it permits changes that will allow all workers in the same job to earn the same amount in each future year, i.e. keep them unified instead of split by resentment.
- Avoiding a "tiered" plan's impossibly complicated administration saves several millions per year in administrative costs.

I hope all parties take today's problem seriously enough to solve this problem themselves, for I fear everyone stonewalling until an outside solution is imposed on us, will just put all workers into an "individual account" plan. Taxpayers will love that solution, but I suspect government workers ... not so much.

# CIVIL BEAT

Thursday, February 24th, 2011

## Dear Legislator: Don't Pass Any Retirement Bills

**Editor's note:** *This is a copy of a letter George Berish sent to every legislator in Hawaii. Berish wrote a four-part series for Civil Beat on the state of the Hawaii Government Employees' Retirement System:*

- Hawaii's Retirement System — A Danger Demanding Sunshine
- A Danger Demanding Sunshine — The Consequences of Hawaii's Public Pension Shortfall
- The Why and What Of 'Retirement Systems'
- A Way To Save Hawaii's Government Employees' Retirement System

*He followed up with this letter to lawmakers regarding the bills before the Legislature this year.*

Dear Legislator:

I write as a 35-year Fellow of the Society of Actuaries. I'm acting pro bono for the interests of my neighbors, your constituents, and our fellow Americans whose home is Hawaii.

My relevant education, training, experience, and credentials are the equal of, and in some cases exceed, those of the actuary engaged on behalf of government workers by the outside board of Hawaii's Government Employees' Retirement System (HERS) who is paid from public assets.

My subject is the collection of Bills submitted to modify the HERS (I think it's about a dozen and I assume each has a partner in the other house).

My advice is that with a few exceptions these Bills only make an already bad problem worse. The exceptions are a couple constituent-pleasing gestures that do no material harm or good, and the one fair and intelligent Bill Gov. Abercrombie was crudely insulted for defending.

And it is a very bad problem. That's because earlier, equally ill-conceived, legislation, has led to a 10-year deterioration of HERS funding that took the market value of public assets set earmarked for HERS benefit payments declining from 103% of the amount taxpayers owed government workers for work they have already done (6/30/2000) to almost \$9 billion short of that amount.

So my plea is that you NOT PASS any of these Bills this session. More specifically, please do not allow yourself to be stampeded into more bad decisions as you were by stampeded by a prior governor and HERS board into discontinuing actuarial cost method funding effective 2005. As a professional actuary I am qualified to advise you that you have plenty of time to fix this problem correctly, and your best choice is to make time -- after this almost insanely crowded legislative session -- to determine how to fix the HERS right this time -- and I sincerely offer that advice.

Note: Contrary to "conventional wisdom", for so long as you do not increase benefits further, paying benefits "as you go" will always cost less per year than funding them ... forever. I know you've been told otherwise, and even by "actuaries" who spoke without thinking. But that's the problem -- so much of the oral tradition wrapped around retirement systems that everyone "just knows to be true" is false. [An aside that may help you understand my statement, is that funding has only one purpose -- to prevent you from imprudently increasing benefits. Otherwise the cost of existing benefits is fixed forever by the law that defines them, and has nothing to do with how, or if, they are funded. How could it when the benefits are "definitely determined" by law and hence unaffected by funding? Hence my point: Refraining from increases will give you the time to do it right -- when you have more time to do it right. I only recommend setting all bills aside, because that seems politically possible, whereas picking some but not the others does not. ]

I am willing to devote any amount of time you request to help you make a more fully informed decision on these Bills and to craft the changes needed for you to save Hawaii's "definitely determinable benefit" plan for government workers and protect the interests of my clients and your constituents.

But to avoid wasting you precious time I'll start by only providing the following list of factually correct statements concerning the process used to create past and present Bills. If you cannot see in this process enough reason to stop and reconsider the wisdom of your actions more carefully, I doubt you will be interested in more detailed actuarial reasoning or advice.

- The Bills were drafted by lawmakers and staff. None are actuaries qualified in matters involving funding of "definitely determinable benefit" plans. None secured direct advice from, or review of the Bills by, a qualified actuary engaged on behalf of the general public.
- Advice related to the funding deterioration comes exclusively from, or through, the HERS executive director. He is self-taught in these matters with no relevant credentials. He speaks for the HERS' outside board whose members have publicly declared an exclusive "fiduciary duty" to government worker interests. More specifically, they claim that duty affirmatively prohibits them from considering the effect of their decisions on the public's, or taxpayers', interest.
- I've been told the only actuarial advice received by the drafters allegedly originated with the HERS board's actuary, and was filtered through the executive director, i.e. direct access of lawmakers to the HERS board's actuary is denied. From my participation in the board's actuary selection process, I know prospective board actuaries are instructed that their client is the HERS board who represent the interests of government workers. More specifically, they are told their client is not elected lawmakers who represent the interests of the public – government and non-government workers alike. The danger of second hand professional advice seems self-evident. For example, people who lack professional credentials are free to take greater liberty in their interpretation of a professional's work product than standards of professional conduct allow a professional to take.
- Finally there is the board's illogical claim of a "fiduciary duty" to government workers. I know you know that "fiduciary duty" cannot exist unless a person has discretionary power to affect the interests of person to whom the duty is owed. So please note that PL-88 gives the HERS outside board absolutely no discretionary authority to materially affect one penny of retirement benefits it grants to government workers. Hence the board's only duty to workers is the correct calculation and payment of benefits in strict compliance with PL-88 – a ministerial, not fiduciary, duty. The only discretionary authority given to the board relates to directing the investment of billions of public assets. In that regard, the public, and especially the taxpayers, bear 100% of the risk for those decisions. So the board's claim it owes a fiduciary duty to workers whose interests it has no discretionary authority to affect, but no duty at all to the public whose interests it has great power to affect – as demonstrated by its contribution to the funding deterioration – seems logically absurd. If there is "fiduciary duty" it is to the public. If you disagree I'd love to know your legal reasoning for doing so.

NOTE: Quite literally, if the board lost the rest of the public assets it invests, doing so would not affect a single penny of the worker's accrued benefit. Taxpayers would bear 100% of the loss, because our full faith and credit, not the public assets, guarantee payment.

If I can help, let me know. If not, all I can do is warn you that continuing to pass Bills by this process will just add more harm to that already done by the \$9 billion shortfall produced by earlier Bills produced by the above process.

Sincerely, George L. Berish, F.S.A.