

SB 1216

Testimony

TESTIMONY BY WESLEY K. MACHIDA
ADMINISTRATOR, EMPLOYEES' RETIREMENT SYSTEM
STATE OF HAWAII
TO THE SENATE COMMITTEE ON JUDICIARY AND LABOR
ON
SENATE BILL NO. 1216

FEBRUARY 11, 2011

RELATING TO ACTUARIAL ASSUMPTIONS FOR THE
EMPLOYEES' RETIREMENT SYSTEM

Chair Hee and Members of the Committee:

S.B. 1216 reduces the investment return rate assumption from 8% to 7.75% and authorizes the ERS Board of Trustees to set the investment return rate assumption after June 30, 2011, based on the recommendations of the actuary. The ERS Board of Trustees supports this bill as it seeks to set a realistic investment return rate assumption.

The ERS Board of Trustees has the fiduciary responsibility of adopting actuarial assumptions that impact the funding of the ERS. The ERS Board of Trustees has the statutory authority to adopt all of the actuarial assumptions except for the investment return rate. The investment return rate is currently set by Hawaii state statute at 8%. The ERS exceeded the assumed 8% investment return rate for five of the past ten years; however, it fell below the 8% return rate for the other five years, resulting in an average return rate of approximately 3% for the past ten years. Although the past ten years may not be a reliable indicator for the future, several ERS investment managers have indicated that it will be extremely difficult to achieve an 8% average investment return rate over the next ten years. Many public pension plans have decreased or are contemplating a reduction to their investment return rate to 7.75% or even 7.5%. Based on analysis and the recommendations of the ERS Actuary and Investment Consultant, the ERS Board of Trustees approved a decrease in the investment return rate assumption from 8% to 7.75%.

The ERS Board of Trustees should be allowed to establish the investment return rate based on recommendations by its Actuary and Investment Consultant. The investment return rate assumption is used to determine the funding level of ERS and contribution rates for employers. If the investment return rate

assumption is not realistic, the funding level of the ERS could either be understated or overstated, and employer contribution rates may not be set at levels appropriate to meet the long-term costs of the ERS. If the investment return rate assumption is set by statute, then the Board may be required to assume additional risk to meet this rate. The additional risk could result in achieving the statutory rate; however additional risk could also result in severe underperformance during difficult economic times, thereby further increasing the ERS's unfunded actuarial accrued liability, which is currently reported at \$7.1 billion.

The ERS Board of Trustees therefore supports the passage of this bill. Thank you for the opportunity to testify on this important measure.

TESTIMONY OF COLBERT MATSUMOTO

Chairman of the Board of Trustees
Employees' Retirement System of the State of Hawaii

SENATE COMMITTEE ON JUDICIARY AND LABOR

Senator Clayton Hee, Chair
Senator Maile S.L. Shimabukuro, Vice Chair

February 11, 2011

9:15 a.m.

State Capitol, Conference Room 016

Senate Bill No. 1216

Senate Bill No. 1341

On behalf of the Board of Trustees of the Employees' Retirement System of the State of Hawaii ("ERS"), I offer this testimony in support of the above-referenced bills that are aimed at ameliorating the rapidly rising public employees pension contribution burden faced by the State and counties.

The unfunded liability of the ERS will continue to place a rapidly escalating financial burden on the State and the counties ("Public Employers") as the annual required contribution ("ARC") grows both as to the required rate of contribution as well as the dollar amounts. This would not be a concern if the Public Employers were readily able to satisfy the ARC. However, doing so will be increasingly daunting as the rising number of retirees and the pension benefits payable to them accelerates beyond the expected rate of growth of both Hawaii's economy and public revenue sources.

If the invested assets of the ERS stood at a much higher level rather than its presently low funded ratio, the burden on the Public Employers would not be as great since the ERS would be able to generate greater cash returns on its larger investment base. The fact that the assets of ERS have declined from 95% to a 61% funded ratio means that fewer dollars generated from investments are available to pay the current pension benefits owed to our rapidly increasing pool of public employee retirees.

To depict the problem simplistically, imagine if the ERS were fully funded with \$18 billion, the targeted 8% rate of return would generate almost \$1.5

billion in total return. That would likely be enough to meet the approximately \$1 billion in cash benefits payable to current retirees. However, because the ERS only has \$11 billion in assets, a targeted 8% rate of return would generate less than \$900 million in total return. Since most of the total return is illiquid, not enough cash is generated to fund required pension payments. That is why the ARC from the Public Employers is critical to ensure that the ERS has sufficient cash to pay the pension benefit obligations without having to sell off more investments and further undermine its funded ratio.

Consequently, the Public Employers must today contribute 15% of payroll for general employees and 20% of payroll for police and fire employees rather than merely the 6% “normal cost” for currently accruing pension benefit liabilities. The dollar contributions have grown at an annual double-digit rate from \$166 million in FY 2002 to \$550 million in FY 2010.

Unless something in the current design of the public employees pension plan changes, the ERS will soon need to seek an increase in the rate of contributions from the Public Employers to 19.5% of payroll for general employees and 28.5% of payroll for police and fire employees to maintain the financial integrity of the plan design.

Recognizing that the annual payments required of the Public Employers are growing at a rate that could overwhelm their financial resources and consequently, the stability of the ERS, the Board of Trustees of the ERS have put forth proposals to modify the design features of the public employees pension plan as set forth in the above-referenced Senate Bills.

The proposed legislation will only affect new public employees by reducing the pension benefits they would accrue as compared to that of current public employees. No doubt these changes will not be popular. Moreover, the fiscal impact and the relief derived from these changes will be slight in the near term. However, without these modifications, the Public Employers can expect that the pension contribution burden they are struggling with today will worsen in years ahead.

On behalf of the Board of Trustees of the ERS, I urge you to support SB 1216 and SB 1341 with the recognition that the measures they contain are important steps in dealing with the grave financial challenges facing the State and the counties.