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Serving those who serve South Carolina

Understanding the S.C. pension funding legislation

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The South Carolina retirement plans were created to provide retirement benefits for those who serve South Carolina. The largest of the plans, the South Carolina Retirement System or SCRS, and the Police Officers Retirement System or PORS, had a combined $27.9 billion trust fund as of June 30, 2016. In 2016, $3.04 billion in annuities were paid to current retirees and beneficiaries from PEBA's five defined benefit retirement plans. Nearly 94 percent of these annuitants live in South Carolina, representing a potential $2.84 billion impact on our state's economy. While that is more than the personal income derived from utilities, farming and forestry/fishing[1], the plans' benefits are far from generous. The average annual benefit for all SCRS annuitants was $20,068 as of July 1, 2016.

The retirement plans not only cover employees of state agencies, but also employees of counties, cities, school districts, higher education institutions, fire districts and other political subdivisions. Including active, inactive and retired members of the plans, the retirement systems directly impact 11.5 percent of South Carolina's population.

The South Carolina Public Employee Benefit Authority (PEBA) administers the state's public pension plans, but state statutes outline pension plan provisions as well as funding requirements. There are only three sources of income for the plans—employer contributions, employee contributions and investment returns.

The pension liability is the amount the plan is obligated to pay all of its members. Approximately 65 percent of the SCRS liability is attributed to members who have already retired and are receiving benefits. The remaining liability is attributable to members who have already accrued service for which benefits will be due in the future. As of July 1, 2016, the actuarially accrued pension liability for SCRS was $45.9 billion. The actuarial value of SCRS plan assets as of July 1, 2016, was $27.29 billion, which means SCRS is 59.5 percent funded.

The actuarial value of the SCRS unfunded liability was $18.57 billion as of the same date. The market value of the SCRS unfunded liability as of July 1, 2016, was $21.86 billion. Both market and actuarial values are used to evaluate the financial status of the plan. The market value is based upon the most current fair market value of the plan's assets at the valuation date. The actuarial value smooths investment performance over time, recognizing investment gains and losses over a five-year period. This smoothing is intended to dampen the effect of year-to-year investment volatility in calculating funding requirements, including required contribution rates.

A combination of unfunded benefits, such as 28-year retirement eligibility, the Teacher and Employee Retention Incentive (TERI) program, as well as ad hoc cost-of-living adjustments (COLAs), which were

[1] United State Bureau of Economic Analysis, 2016 Personal Income by Major Component and Earnings by NAICS Industry

granted prior to the 2012 reform, have increased the unfunded liabilities of the plans. Lower than expected investment returns have also contributed to the increase of the unfunded liabilities of the plans. The plan's unfunded liability is the difference between the eventual payments the plan must make to members and their beneficiaries and the current funds on hand to pay these obligations.

The Joint Committee on Pension Systems Review began meeting in August 2016, and PEBA is actively working with the Joint Committee members as they address these funding challenges. In reviewing the plans' funding challenges, the Joint Committee set three funding priorities for the plans: recognizing and paying down deferred investment underperformance; lowering the assumed rate of return for the plans' investments; and reducing the period for paying off the plans' unfunded liabilities.

Why is the current pension legislation important?

H.3726 represents the culmination of efforts on the behalf of many people and organizations. Both the Board of Directors of PEBA and the General Assembly made the sustainability of our state's pension plans a priority that was handled deliberately.

The pension legislation takes several important steps to increase funding to the retirement systems, which improves the financial condition of the plan more quickly and incorporates a cushion for some future adverse investment experience.

Decreases the assumed rate of return effective July 1, 2017
The legislation lowers the assumed rate of return for the plans' investments from a 7.5 percent annual return to a 7.25 percent annual return. This assumed rate of return will remain in effect through July 1, 2021, at which time a new rate would be set by the General Assembly based upon a recommendation from the consulting actuary and PEBA. A reduction in the assumed rate of return means that the systems are expecting less investment income, which will require an increase in contributions to maintain the same total income, or revenue, for the plans.

Relying on more predictable contribution income streams, rather than on less certain investment returns, will help reduce the impact of any possible future investment underperformance on the plans' funding progress.

Changes employee and employer contribution rates effective July 1, 2017
The employee contribution rate for SCRS increases to and is capped at 9 percent. The employee contribution rate for PORS increases to and is capped at 9.75 percent. The employer contribution rate for SCRS and PORS increases by 2 percent to 13.56 percent and 16.24 percent respectively. The employer rates will continue to increase annually by 1 percent through July 1, 2022. The legislation's ultimate scheduled employer rate is 18.56 percent for SCRS and 21.24 percent for PORS.

The scheduled contribution rate increases are designed to proactively improve the plans' financial condition, even if future investment performance does not meet the assumed return expectations.

Reduces the funding period
The funding period, or amortization period, is the time allowed for paying off the plans' unfunded liabilities. The legislation gradually reduces the maximum funding period from 30 years to 20 years by July 1, 2027. While the scheduled contribution rate increases are expected to be sufficient to meet the

20-year maximum funding period, the legislation also provides additional financial security in the event there are significant investment losses in future years.

With a funding period of 20 years or below, the plans would no longer experience negative amortization. Negative amortization occurs when the annual required contributions are not enough to pay the interest that is accruing on the unfunded liability. When the plans reach a 20-year amortization period, the annual required contribution will be paying all of the interest and will start to pay down the principal, or the unfunded actuarial accrued liability. This interest is simply an actuarial calculation, and does not represent an actual interest payment that must be made to a lender or other third party.

Reducing the plans' funding period is essential to improving the plans' funded status and ensuring that contributions remain sufficient to finance the unfunded liability in future years.

How is this legislation funded?

While the costs of these steps to improve the plans' funded status are significant, it's important to emphasize the increased funding provided by this legislation is intended to pay the legacy costs of benefits that have already been accrued by members in the plans. The plans have constitutional and statutory obligations to pay these benefits to their members.

Increasing an SCRS employee's contribution to 9 percent of pay means that the employee is funding 88 percent of the cost of his benefit earned that year. Data from the National Association of State Retirement Administrators (NASRA) shows the median employee contribution rate for retirement systems similar to South Carolina's was 6 percent for fiscal year 2015. As of July 1, 2016, the employee contribution rate for SCRS was 8.66 percent, and the average salary of an active member of SCRS was $41,330. From that salary, the member contributes 8.66 percent to SCRS and another 6.20 percent for Social Security. As recognized by the Reason Foundation in its presentation to the Joint Committee, one of the risks of inaction on retirement systems' legislation is that rising employee contribution rates will make it difficult to hire or retain public sector workers in South Carolina.

The increased funding for the retirement systems produced by the proposed legislation is significant. However, the extent of this increased funding must be viewed in the context of the full scope of the retirement systems. As mentioned previously, the retirement systems not only include employees of the state, but also employees from some 800 state and local governmental employers, such as counties, cities, school districts, fire districts and other political subdivisions. Between active, inactive and retired members of the systems, the retirement systems directly affect 11.5 percent of the state's population. As of July 1, 2016, the total covered payroll for positions contributing to SCRS was $10.5 billion.

Each 1 percent increase in the employer contribution rate equals $118.1 million in additional contributions to SCRS and PORS. The scheduled employer contribution increases are expected to generate an additional $827 million in annual funding for the plans by July 1, 2023. However, this additional funding is not solely derived from the state's General Fund dollars. Approximately 31 percent, or $36.8 million, comes from the General Fund annually. Local governments pay $33.7 million and the remaining $47.7 million is derived from federal or other funds.

The median employer contribution rate for retirement systems similar to South Carolina's was 12.9 percent for fiscal year 2015 according to NASRA. As of July 1, 2016, the SCRS employer contribution rate was 11.56 percent.

Summary

The measures taken by the pension legislation to improve the funding status of the plans, although difficult, are necessary to recognize the costs of prior investment underperformance and to fund the plans' already-accrued liabilities on a fiscally-sound schedule that goes above minimum funding requirements. It is for that reason that rating agencies and other external groups that review pension funding find the steps taken by this legislation a positive action for the state and its political subdivisions.

It is also important to recognize that this legislation does not change the benefits provided to members of the retirement systems. Additionally, changes to the plan design, which are not included in the legislation, do not reduce the current unfunded liability. The state and other participating employers in the retirement systems will still have an obligation to make necessary contributions to pay off the existing liabilities of the retirement systems.

The Joint Committee has publicly stated that they will continue their work by evaluating plan design as a second phase of the retirement reform legislation. PEBA will continue to work with the Joint Committee during its evaluation.

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