Ten Facts About Oklahoma's Retirement Systems Your Legislators Should Understand But Probably Don't Because They Haven't Been Told

1. Oklahoma Teachers Retirement System (OTRS) is on track to be fully funded in 11 years.

2. Once fully funded the current benefit structure of OTRS is clearly affordable because only $420 million of $1,008 million collected in FY2014 was needed to sustain the current level of benefits.

3. OTRS has an outstanding record for investment performance, far better than individual members in a defined contribution system are likely to do on their own.

4. OTRS members have "portability" within its current defined benefit plan if they should leave teaching.

5. Legislators who voted to create the new defined contribution system for new state employees in 2014 did not follow the law in place to protect Oklahoma public pensions from underfunding.

6. Creation of the defined contribution plan for new state employees did nothing to reduce the unfunded liability of the existing OPERS defined benefit plan and may make it worse.

7. Individual defined contribution plan investors pay higher administrative and marketing costs and their plans have higher financial management and trading fees than what OTRS and OPERS pay.

8. Legislation in 2015 to create a new defined contribution system for new teachers will weaken the current OTRS defined benefit system, will deliver no greater benefit to new teachers, and not only will do nothing to reduce the unfunded liability (UAAL) of OTRS, it may make it worse.

9. The only certain beneficiary of creating a defined contribution plan for new teachers will be the financial services industry.

10. Changes to OTRS may violate the Oklahoma Constitution.

Sources and Explanations

1. Oklahoma Teachers Retirement System (OTRS) is on track to be fully funded in 11 years.

According to the most recent actuarial study for FY2014 OTRS is projected to be fully funded in 11 years. This is an amazing improvement from the “infinite” projection in the FY2010 study which meant the system would never be fully funded. This dramatic turnaround is the direct result of several important changes to OTRS in recent years. Because the 2011 Legislature made COLA’s subject to the stringent requirements of the Oklahoma Pension Legislation Actuarial Analysis Act (OPLAAA) the actuary removed the assumption of annual 2% COLA ‘s which reduced the unfunded liability by some $2 billion. Required school district contribution rates have steadily increased from 1% in 1990 to 9.5% in 2011. The State’s contribution has increased from 3.25% of general revenue available for appropriation in FY2000 to 5% in FY2008. Since 1992 all new members are on the Rule of 90 benefit calculation. Bottom line is that changes made over 20 years have resulted in a system that is healthy and on rapid course to full funding. The unfunded actuarially accrued liability (UAAL) that is $7,207 million now is projected to be reduced to nothing in 11 years.

2. Once fully funded the current benefit structure of OTRS is clearly affordable because only $420 million of $1,008 million collected in FY2014 was needed to sustain the current level of benefits.

According to the FY2014 actuarial report the “normal cost” to maintain the system at current benefit levels, if the system were fully funded, is $419.3 million. The balance of what was collected, $589 million, is going to pay for the system’s accumulated unfunded actuarially accrued liability (UAAL), which at this rate will be fully funded in 11 years. Upon full funding OTRS contributions can be reduced by that amount--$589 million and the system will remain sound at the current benefit levels. Of the $1,008.3 million the system received in FY2014, $301.3 million came from employees, $411.2 million from employers and $295.8 million from state earmarked revenues.

3. OTRS has an outstanding record for investment performance, far better than individual members in a defined contribution system are likely to do on their own.

According to the Oklahoma State Pension Commission Investment Summary reported as of September 30, 2014, OTRS has been the top performing defined benefit public pension system out of 143 reviewed nationally with an annual return of 8.9% over the last ten years; it also was the top performing system out of 196 nationally in FY2013 with a return of 13.4%. By contrast the research is clear and overwhelming that individual investors consistently underperform market averages and professional managers to their financial detriment. For a good summary of the reasons see page 4 of *The Oklahoma State Worker Pension Plan: If It Ain't Broke, Don't Break It* brought to us by the Oklahoma Policy Institute (OPI) at the link:

http://www.epi.org/publication/oklahoma-state-worker-pension-plan-aint/

It's not surprising that the Oklahoma Council of Public Affairs (OCPA) in its policy paper *Saving Workers' Retirement*, which is the roadmap for Oklahoma legislators who are committed to eliminating all of Oklahoma's defined benefit pension plans, makes no mention of this research which is well known to anyone who has studied the performance of individual investors in the United States. Here are more examples found by searching on "average individual investor performance".

http://online.barrons.com/articles/SB50001424053111904628504579417240784185458

http://www.financial-math.org/blog/2014/05/latest-dalbar-report-underscores-poor-long-term-performance-of-individual-investors/

http://www.umass.edu/preferen/You%20Must%20Read%20This/Barber-Odean%202011.pdf

http://www.forbes.com/sites/advisor/2014/04/24/why-the-average-investors-investment-return-is-so-low/

My own "research", more than the OCPA presents on individuals' investment performance, reveals that in FY2013 participants in the Oklahoma State Employees Deferred Savings Incentive Plan (OSEDSIP) and in the Deferred Compensation Plan managed average annual returns of about 9.7% and 10.1% respectively by selecting from funds which had returns ranging from 17.36% to minus 9.16%. These Plans are the model for the new defined contribution system purportedly established by the 2014 Legislature for state workers and therefore a fair example of defined contribution investment performance (see Title 74, Okla. Statutes, Sect. 935.9). By contrast the state workers defined benefit pension plan (Oklahoma Public Employees Retirement System, OPERS) realized an annual return of 11.95%; again, OTRS earned 13.4%.

4. OTRS members have "portability" within its current defined benefit plan if they should leave teaching.

This from the OTRS website: "Upon termination of employment the member may withdraw all contributions and refundable interest. Interest is refundable based upon years of membership (date of first contributions) and in accordance with the following schedule: Up to 16 years of membership 50% of accumulated interest At least 16 years but less than 21 years 60% of accumulated interest At least 21 years but less than 26 years 75% of accumulated interest 26 years or more 90% of accumulated interest Note: Since July 1981, the interest rate set by the Board of Trustees is 8% compounded annually."

5. Legislators who voted to create the new defined contribution system for new state employees in 2014 did not follow the law in place to protect Oklahoma public pensions from underfunding.

The Oklahoma Pension Legislation Actuarial Analysis Act (OPLAAA), Title 62, Okla. Statutes, Sect. 3101 et seq., was enacted by the 2006 Legislature to deter future legislatures from increasing pension benefits or from establishing new retirement systems without an actuarial analysis of the financial impact. HB2630 was introduced and passed during the 2014 legislative session closing the current defined benefit plan under OPERS to new state employees after November 1, 2015 and establishing a new defined contribution system for them in its place. OPLAAA requires that before "creating or establishing a retirement system" an actuarial analysis must be done to determine the fiscal impact of the legislation. It also requires that such legislation can only be introduced in an odd-numbered year and only passed in an even-numbered year.

The legality of HB2630 is being challenged In the Oklahoma County litigation, *Stevens v. Spencer*, supported by the Keep Oklahoma Promises coalition. The defendants who maintain that HB2630 is valid confirm that the 2014 Legislature did not follow OPLAAA because no actuarial analysis of the new defined contribution system, or of its impact on the existing OPERS defined benefit system, was performed (*see page 11 of the Defendants' Motion to Dismiss where it states "By its plain terms, HB2630 creates an entirely new pension plan that applies only to new employees hired after the effective date of the statute"*). However they argue that OPLAAA is merely a "procedural" law which the legislature is not required to follow.

Regardless of the outcome of this litigation, the fact is that legislators enacted a new law affecting thousands of state workers and involving hundreds of millions of taxpayer dollars without seeking the benefit of actuarial studies to determine the law's impact on the current and proposed retirement systems and on the retirement security of new state employees. Implementation of OPLAAA has greatly improved the fiscal soundness of Oklahoma's public pension systems, yet the 2014 Legislature chose not to follow it.

6. Creation of the defined contribution plan for new state employees did nothing to reduce the unfunded liability of the existing OPERS defined benefit plan and may make it worse.

According to the OPERS 2014 Valuation Report the defined benefit plan ended the fiscal year with an unfunded actuarially accrued liability (UAAL) of only $994 million, a significant reduction from $1,577 million the previous year due primarily to the increase in the valuation of OPERS assets. Using the market value of assets the system is now over 97% funded—certainly no danger to the state's fiscal health. Concerning the 2014 legislation affecting OPERS the actuary states:

Senate Bill 2120 and House Bill 2630 will, in combination, significantly reduce the number of new members entering the plan after November 1, 2015. While this has no impact on any of the valuation results in this report, there are potential ramifications of this legislation that will affect on-going plan funding. In particular, the current amortization of the UAAL is based on the assumption of increasing payroll.

While the new legislation may have no certain impact on the UAAL the system's actuary could reasonably determine that the assumed rate of return used to calculate the actuarial value of assets will be reduced. The reasons for this are summarized on pages 2 and 3 of the OPI policy paper cited in Fact number 3 above and would result in a larger UAAL for the OPERS defined benefit system. Additionally the removal of future payments associated with new employees would lengthen the time required to fully fund the OPERS defined benefit system. This impact is confirmed by the OCPA policy paper referenced in Fact number 3 above which shows the period to full funding would lengthen from 12 years (2013 calculation) to 18 years. (See the tables in the Funding Study at the end of the paper: http://www.ocpathink.org/articles/2576)

To correct this obvious problem HB2630 provides for a "remit the difference" method of continuing funding the OPERS defined benefit system tied to the new state employees no longer in the system until it is fully funded. However, as explained in Fact number 5, the legislature did not obtain an actuarial analysis so they enacted HB2630 without being fully informed about whether it would worsen the UAAL of the existing defined benefit OPERS system or of what retirement income the new defined contribution system is likely to produce for its participants. The OPERS actuary states:

The current provision of the new legislation should provide at least as much toward the UAAL as would have been expected otherwise, so we are comfortable with this methodology. We would encourage the Board to study the long-term impact of this legislation.

Translated, the OPERS Board should now do what the 2014 Legislature failed to do in not following OPLAAA.

7. Individual defined contribution plan investors pay higher administrative and marketing costs and their plans have higher financial management and trading fees than what OTRS and OPERS pay.

These facts are stated, with references, beginning at page 4 of the OPI policy paper referenced in Fact number 3. Oklahoma examples of this are that the administrative costs for the OTRS defined benefit plan are 0.36% of payments while for the state workers defined contribution plan OSEDSIP they are 1.78% (Social Security reports its cost as 0.7%). The financial management and trading fees for OTRS are 0.41% of assets; the industry average for mutual fund investors is 1.08%, such as those in OSEDSIP. Both of these cost differentials between fees and costs for a large collectively managed defined benefit plan compared to the fees and costs borne by individual investors are a significant part of the explanation for the poor investment performance by individuals documented in fact number 3.

8. Legislation in 2015 to create a new defined contribution system for new teachers will weaken the current OTRS defined benefit system, will deliver no greater benefit to new teachers, and not only will do nothing to reduce the unfunded liability (UAAL) of OTRS, it may make it worse.

The roadmap provided to legislators by OCPA in their policy paper *Saving Workers Retirement*, calls for action on OTRS like what HB2630 did to OPERS in the 2014 legislative session (see reference in Fact number 3). The current defined benefit plan under OTRS would be closed to any new members and new school employees would participate in a new defined contribution system administered by OTRS. Best case this change may leave the UAAL, presently $7,207 million, unchanged, however, as stated in Fact number 6, the system's actuary could reasonably determine that the assumed rate of return used to calculate the actuarial value of assets will be reduced resulting in a larger UAAL. Additionally the removal of future payments associated with new employees will lengthen the time required to fully fund OTRS. This is not only confirmed by those opposed to such a change, like the OPI, but also by the *Funding Study* addendum to the OCPA policy paper referenced in Fact number 3 which shows the period would lengthen from 22 years (2013 calculation) to 35 years.

The arguments presented in the OCPA paper are factually outdated and supported more by ideology than sound analysis. Notably the *Funding Study* addendum, written by an actuary, contradicts much of the OCPA position by stating:

Many sponsors have changed to defined contribution or hybrid plans such as cash balance plans in hopes to save money. However while the benefit accrual patterns of these plans may be different than a defined benefit plan, the only way to reduce costs is to reduce the level of *benefits provided or eliminate other components such as the lifetime income guarantee. The type of plan selected does not inherently make benefits less costly.*

Translated, moving new teachers to a defined contribution system will only save the state money if the retirement benefits provided to them are less than teachers now receive—duh.

9. The only certain beneficiary of creating a defined contribution plan for new teachers will be the financial services industry.

What can we conclude from these facts? The primary stakeholders in this DB vs. DC policy discussion are the state (its people), teachers and the financial industry. The state is obligated for the UAAL of the current OTRS system and moving new teachers to a new defined contribution system does absolutely nothing to reduce that obligation and can make it worse. In 11 years the UAAL is projected to be fully funded and the ongoing cost of the existing OTRS defined benefit system can be sustained with less than 42% of its current revenue which will free up over $500 million annually for other state uses. Unless the state and its people will benefit from greatly reducing the retirement security for future teachers or from paying more to obtain the same level of retirement security for future teachers, the state and its people will not benefit.

The only teachers who are likely to benefit from a new defined contribution system are new teachers who don't plan to remain as teachers in Oklahoma very long. Current teachers who are members of OTRS will, best case, experience no benefit at all or, worst case, will find their existing retirement system weakened and future benefits threatened. New teachers who plan to remain as career teachers in Oklahoma will not have the benefits of the better investment performance and the lower costs and fees enjoyed by current Oklahoma teachers in building assets to finance a secure retirement. Unless the state and its people are willing to pay more in the future for each dollar of retirement benefit to a teacher than is now required, new teachers will have lower retirement benefits than will their colleagues who remain in the current defined benefit system.

As shown in Fact number 3 above, for every dollar of public and teacher funds that go to fund teachers' retirement, the financial services industry will receive a significantly greater, easily doubled, share under a defined contribution system like that to be implemented under HB2630 for state workers than it would from the same dollar staying in the current OTRS defined benefit system.

So if defined benefit systems are so good, how did OTRS get in such trouble that as recently as 2010 it was projected to never be fully funded? The OCPA policy paper puts it this way:

Across the United States of America and the world, defined-benefit retirement plans are in trouble due to an imbalance in promises and resources, a lack of realistic expectations, susceptibility to political misdirection, and inherent cost challenges.

Except for the "inherent cost challenges" I think it is a pretty good summary of what can go wrong. At the same time, properly managed, having a retirement system that can plan and invest for the long term and is large enough to benefit from lower fees, costs and expenses, is of great value to the state and its teachers. The old expression "Don't throw out the baby with the bathwater" comes to mind. In recent years Oklahoma has followed this advice. The "bathwater", namely the "*imbalance in promises and resources, lack of realistic expectations, and susceptibility to political misdirection,* is being thrown out largely due to the implementation of OPLAAA—at least we were until the 2014 Legislature ignored it by passing HB2630 without having the actuarial analyses done as required. The "baby", a smart, efficient, collective, and sound retirement system for teachers, like OTRS is now, needs to be kept and nurtured.

10. Changes to OTRS may violate the Oklahoma Constitution.

If a law proposed for OTRS uses the "remit the difference" approach to replace the contributions lost from new school employees still needed to fund the OTRS defined benefit system UAAL, it may violate Article 10, Section 9 which provides for school district operating property tax levies and also states: *No ad valorem tax shall be levied for State purposes, nor shall any part of the proceeds of any ad valorem tax levy upon any kind of property in this State be used for State purposes.* Translated the "remit the difference" assessment, unrelated to participants in the current defined benefit system, will require school districts to use local property taxes to retire the past UAAL of OTRS which is solely a state responsibility. The 2014 OPERS legislation does not direct expenditures of local property tax revenues and therefore does not face this constitutional challenge.

The authority for establishing OTRS is Article 5, Section 62, of the Oklahoma Constitution which was approved in 1942 by vote of the people at a time when the only public pension plans were defined benefit; it states: *The Legislature may enact laws to provide for the retirement for meritorious service of teachers and other employees in the public schools, colleges and universities in this State supported wholly or in part by public funds, and may provide for payments to be made and accumulated from public funds, either of the State or of the several school districts. Payments from public funds shall be made in conformity to equality and uniformity within the same classifications according to duration of service and remuneration received during such service.* This language describes a defined benefit system so any new law forcing teachers into a defined contribution system will be challenged on the basis that it violates this Article.