Presentation To The

House Standing Committee on Pension and Benefits

Rick Poccia

KPERS Study Committee Commissioner

March 9, 2012

Thank you, Mr. Chairman, for the opportunity to speak before the committee today. My name is Rick Poccia. I was appointed to the Kansas Public Employees Retirement System (KPERS) Study Commission about half way through its course, in October, filling a seat vacated at the time. I am a thirty year resident of Overland Park, Kansas where my wife and I raised two daughters who attended Kansas public schools and received a great education from great teachers who gave them a great experience throughout their time in school.

My professional life started with a stint in the Army where I served for six years as an officer. I then transitioned to civilian life and became a commercial banker which, after thirty-one years, I remain today.

My educational background includes a Bachelor of Science degree in engineering from the U. S. Military Academy at West Point and a Masters of Business Administration Degree from the University of Chicago Graduate School of Business, now known as the Chicago Booth School of Business.

My first experience with the Kansas Public Employees Retirement System goes back to 1982. You may recall that interest rates at the time were as high as 21%. My wife and I had just moved to Kansas and were looking for a home for the three of us, including our first born daughter. We found a home and our real estate agent found a mortgage loan for us .... for a rate of 14.7%. The lender was KPERS. I dare say that if KPERS would have been able to sustain the same rate of return they earned from me in 1982 throughout the last three decades, we wouldn't be talking today about an unfunded liability.

During the several Commission sessions I attended, I heard much, learned much and, given the dimensions of the funding problem, even feared much for the wellbeing of the KPERS program. The size of the unfunded liability relative to the State's revenues and GDP was and remains tremendous though we as a state are not alone in this bind. Over forty states have sought and continue to seek ways to improve their pension circumstances, much like we have been trying to do over the past year

The fact that there is so much attention being brought to bear by so many on the issue of pension reform means to me at least, that the problems have led us to the brink. Reform is necessary in response to past actions or inactions, economic conditions, and what many refer to as an emerging new norm.

I must agree with the many who have come to the conclusion that the current systems and programs employed today by many states and municipalities including Kansas, those referred to as defined benefit programs, are unsustainable and will likely cause us and other states to increase taxes, cut other state programs or, worse yet, fail to keep the promises made to our retired state employees.

But you know this; otherwise KPERS reform would not be such a high priority objective for a House and Senate that already faces a very full agenda of high priority issues.

I will not recite to any great extent the consequences of doing nothing. We all know I suspect, that we cannot leave ourselves with a pension program that requires nearly all of our State's tax revenues to meet required contribution payments. The do nothing option is not an option.

Instead, as a member of the commission who voted in favor of the majority plan, I would like to give you my thoughts as to why I feel the plan provides the framework for a viable approach to providing pension benefits to our state public sector employees while at the same time dealing with the economic realities we now face.

In Kansas, we have not paid our actuarial required contribution over many years leading to an unfunded liability that is estimated to be around $8.0 billion but that according to some, may be as much as double that figure. I have even read that Kansas' unfunded liability can be as high as $20 billion, though I've not seen the calculations and assumptions that lead to such a dire conclusion. The circumstance we find ourselves in, despite whichever number is correct, is a result of reliance on a pension model that was based upon assumptions that never became reality.

The defined benefits program we utilized, and that which continues to exist today, is a program that may have been more applicable in the past when interest rates were more stable, returns on investment less volatile, economic growth more predictable, the United States and State of Kansas economy less susceptible to global events, and when we as a nation had fewer competitors in the global marketplace.

I'm not here to argue the fine points of the Commission's majority report or minority response. The majority report presents a plan that, to me, provides the framework for a departure from a model that is entirely dependent upon defined benefits to one that is dependent upon a defined contribution model. Such a departure, in my opinion, is the right way to go.

The minority report takes issue with many points presented in the majority's plan, and I must say that there is validity in the counter-points and issues raised by the minority, though there is no offering of an alternative plan other than inferring that the current law HR 2194 is the answer.

I voted for a departure from a pure defined benefit plan to one that relies to a great extent on a defined contribution plan for a variety of reasons:

1. The new and changing economic conditions I mentioned previously when describing the current system as more applicable to the past than the present.

2. For reasons that directly relate to the core inner workings of the defined benefit system we now use. It is based on assumptions, a multitude of them, that are difficult to validate, and lend themselves to wishful thinking and hopeful outcomes that, given the size of our unfunded liability, have failed to be realized. It's a system that allows us to push well into the future the pain and consequences of promises made in the present and, in so doing, allows us to take solace in the questionable notion that things will be better in the future, so much so, that we will gracefully grow our way out of our problem.

3. Because it's easy to be fooled.

   If it's one thing I've learned given my time on the commission, it's that actuarial accounting is complex and even at times, mysterious. It starts out simple, as it was described to us by Patrice Beckham, the State's actuary. She simplified, in concept, how the program works by stating that all outcomes are the product of money in, money earned and money out; three straightforward variables. Beneath Patrice's three variables, however, are a myriad of assumptions tied together by hundreds of lines of computer code that incorporate advanced mathematical techniques to determine outcomes. If you have an inquisitive mind, as I do, you will want to peel back the covers and examine the equations. What you find is that each one is, of necessity, tied to a wide variety of assumptions. For example,

   a. What is and what will be the rate of return?
   b. How many employees will be on the state's payroll in 2020?
   c. How old will they be when they retire?
   d. How long will they stay on the payroll?
   e. How much of a raise will they get each year?
   f. How many are male vs. female?
   g. How long with they live?
   h. How long will their surviving spouse live?
   i. And I can go on.

   Change one or more of these assumptions, and you may be able to find an outcome you like. We talk about new norms. By definition, then, the "old norm" that gave rise and justification to the myriad of assumptions made in the model we now use may no longer be valid.

I don't think it's fair to our employees to promise benefits that are based on and justified by such a wide variety of assumptions. We need a model that more accurately reflects reality, is significantly less dependent upon multiple assumptions and is considerably less complex. We need a model that is based more on arithmetic than on statistical and regression analysis. We need a model that you and I and every future legislator, as well as the State's taxpayers and employees at large, can understand.

The failure of our past defined benefit plan as evidenced by the significant unfunded liability, the new norm or norms we are facing and will continue to face, the difficult to predict future economy and the likelihood that it will become increasingly difficult and risky to construct valid assumptions about the future, have all caused me to reject our current defined benefit pension system as the appropriate course of action going forward.

I have been in the private sector for over thirty years working as a financial professional. During those thirty years, I have never experienced or seen a private sector defined benefit plan. They were, for the most part, terminated a long time ago. Even large corporations, such as utilities that can be considered quasi-public sector entities, have terminated their defined benefit plans and converted to defined contribution programs.

I find value in some of the more obvious benefits of a defined contribution plan. They are portable and can provide a high degree of employee control over investments. In addition, what is left in the fund at death can be passed on to one's survivors. While there is "downside" risk ", the risk of low returns due to volatility in the investment marketplace, there is also an " upside". A defined contribution plan allows an employee to take advantage of "upside" higher returns.

One of the speakers to the Commission spoke of an emerging demographic. I interpreted this term to describe a younger generation of men and women entering or progressing through their early years in the workplace. Their average stay at one job is, apparently, much less than that of previous generations of workers. The presenter estimated that, as a result of the emerging demographic, the average tenure of a public employee is declining to what is now between seven and eight years. Whatever pension program emerges from this session of the legislature will target this emerging demographic. This target market for talent may differ significantly from what we know exists today. We are, in essence, in the product development business developing a pension product that we hope is attractive to an emerging demographic target market.

I have heard of the tremendous cost of converting to a defined contribution plan. Information technology and organizational infrastructure changes can lead to a cost, some say, in excess of $1.2 billion. Let us be cognizant of the cost of change that will be imposed on the KPERS and municipal administrative staffs but let's not use such costs as a reason not to move ahead. Modernization will be necessary sometime in the future. Such costs cannot entirely be avoided even under a do nothing scenario.

I feel the reasons to move from total reliance on a defined benefit plan to a defined contribution plan are as compelling as they are necessary. We can't wish away the unfunded liability problem or think we've solved it by changing some assumptions in a model. The only sure way to keep from digging ourselves deeper into a hole of unfunded liabilities is to move away from the model that got us there in the first place. I hope we can do so.

Mr. Chairman, I want to thank you and the other members of the committee for giving me the opportunity to speak before you today. I would like to thank all the other members of the Commission who, throughout the process, were professional, respectful and sincere in their desire to improve the pension program. I also want to express my gratitude to those union members and other interested parties who attended the Commission meetings. They were all, bar none, respectful and willing to sit through hours of presentations and discussions. Thank you as well to the retired teacher who made us cookies and those who took the time to write letters and respectfully articulate their point of view.

Finally, on a personal note, I would like to thank those responsible for offering me the opportunity to serve the State of Kansas as a participant in this all important effort.