TESTIMONY BY WESLEY K. MACHIDA
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
STATE OF HAWAII
TO THE SENATE COMMITTEE ON WAYS AND MEANS
ON
HOUSE BILL NO. 1356, S.D. 1

April 2, 2015

RELATING TO UNFUNDED LIABILITIES

House Bill No. 1356, S.D. 1, establishes the Rate Stabilization Reserve Fund (RSRF) to stabilize the Hawaii Employer-Union Health Benefits Trust Fund (EUTF) when there is insufficient money to cover the costs of providing benefits to employee-beneficiaries and dependent-beneficiaries. The measure will also cap the employer contributions to the separate trust fund when the separate accounts for each public employer within the separate trust fund have a combined balance of at least $2 billion. The measure also allows the EUTF to invest moneys in the same manner as the Employees' Retirement System (ERS).

The Department of Budget and Finance strongly opposes this measure. Act 268, SLH 2013, mandated the establishment of the Other Post-Employment Benefits (OPEB) trust fund for the purpose of receiving employer contributions that will prefund OPEB costs for retirees and their beneficiaries. Act 268 required the EUTF Board of Trustees to "establish and maintain a separate account for each public employer within the separate trust fund to accept and account for each public employer's contributions. Employer contributions to the separate trust fund shall be irrevocable, all assets of the fund shall be dedicated exclusively to providing health and other benefits to retirees and their beneficiaries."

House Bill No. 1356, S.D. 1, conflicts with the provisions of Act 268 by taking funds from the OPEB trust fund and depositing them into the RSRF to fund some of the very benefits that the OPEB trust fund will accomplish through pre-funding. It is akin to taking money from the ERS to deposit into another revolving fund to make pension contribution payments to the ERS.

Further, the provisions of Act 268 provided for pre-funding of the State's Annual Required Contribution (ARC) for OPEB beginning with a 20% funding of the ARC in FY 15 and progressively increasing to 100% funding of the ARC in FY 19. The rating agencies, who review and rate the State's debt have stated that progression to 100% funding of the ARC is a substantial credit positive and will yield long-term benefits in reducing the State's unfunded OPEB liabilities. While it is recognized that fully funding the ARC results in substantial annual budget requirements, the pre-funding of the OPEB liability, similar to the annual contributions to the State's ERS, significantly addresses the State's unfunded OPEB liabilities. We are very concerned that termination of the 100% OPEB ARC funding would be viewed as a credit concern and may negatively impact the State's credit rating.

This measure will not reduce the unfunded actuarial accrued liability of the EUTF or meet with the Governmental Accounting Standards Board's requirements for OPEB trusts.

We support the provisions relating to allowable EUTF investments.

DAVID Y. IGE
GOVERNOR

STATE OF HAWAII
HAWAII EMPLOYER-UNION HEALTH BENEFITS TRUST FUND
P.O. BOX 2121
HONOLULU, HAWAII 96805-2121
Oahu (808) 586-7390
Toll Free 1(800) 295-0089
www.eutf.hawaii.gov

BOARD OF TRUSTEES
VACANT, *CHAIRPERSON*
MARIA ZIELINSKI, *VICE-CHAIRPERSON*
LINDA CURRIVAN MUSTO, *SECRETARY-TREASURER*
RANDY BALDEMOR
RODERICK BECKER
AUDREY HIDANO
NOLAN KAWANO
KAROLYN MOSSMAN
CELESTE Y.K. NIP
CLIFFORD UWAINE
JULIA ZEGHMI

ADMINISTRATOR
SANDRA L. YAHIRO

TESTIMONY BY SANDRA YAHIRO
ADMINISTRATOR, HAWAII EMPLOYER-UNION HEALTH BENEFITS TRUST FUND
DEPARTMENT OF BUDGET AND FINANCE
STATE OF HAWAII
TO THE COMMITTEE ON WAYS AND MEANS
ON
HOUSE BILL NO. 1356 SD 1

April 2, 2015, 9:00 a.m.

RELATING TO UNFUNDED LIABILITIES

Chair Tokuda, Vice Chair Kouchi, and Members of the Committee:

The Hawaii Employer-Union Health Benefits Trust Fund (EUTF) Board of Trustees strongly supports Section 3 of this bill and strongly opposes Sections 1, 2, 4 and 5. The EUTF Board of Trustees (EUTF Board) recommends passage of Section 3 of HB 1356 SD 1 with an immediate effective date and deletion of Sections 1, 2, 4 and 5.

Section 3 contains the main provisions of SB 1085 which was proposed on behalf of the EUTF Board. Section 3 amends the EUTF statute HRS 87A-24(2) to permit investment by the EUTF in the same asset classes as the ERS. Currently, HRS 87A-24(2) permits, through a reference to the ERS investment statute HRS 88-119, EUTF investment in only certain asset classes. The following are the reasons and benefits for passage of Section 3 and the negative impacts of not passing Section 3:

1. At their January 28, 2014 board meeting, with the projected growth in the assets as a result of Act 268, SLH 2013 (Act 268), the EUTF Board adopted a

revised asset allocation. The revised asset allocation increased the expected return to 7% from 6.5% with minimal increase in risk through further diversification of the portfolio.

2. Later in 2014, the EUTF determined that certain asset classes included in the revised asset allocation, namely covered calls and commodities, were not permitted under HRS 87A-24(2).
3. The EUTF OPEB Trust is projected by the EUTF actuary, Gabriel Roeder Smith & Company (GRS), to grow to over $6 billion within the next 10 years through contributions as a result of Act 268 and investment earnings. The EUTF should be permitted to invest in the same asset classes as the ERS to maximize returns within prudent levels of risk.
4. As of July 1, 2013, GRS determined the State's actuarial accrued liability to be $8.5 billion using a discount rate (same as the expected return) of 7%. If the EUTF is not allowed to invest in the new asset classes, the actuary may require that the EUTF use 6.5% as the discount rate. GRS has calculated the State's actuarial accrued liability to be $9.2 billion as of July 1, 2013 using a 6.5% discount rate which is a $700 million or an 8% increase.

While Sections 1, 2, 4 and 5 of the bill purport to address the unfunded liability, we do not understand how it is accomplished. The EUTF Board believes that the following are effective ways to address the unfunded liability:

1. <u>Through employer contributions to the OPEB Trust</u> – the legislature has addressed this issue through the passage of Act 268 which provides a funding mechanism to pay down the original unfunded liability over a period of 30 years.

2. Maximizing OPEB Trust investment earnings – the EUTF Board is attempting to maximize investment earnings through Section 3 of this bill.
3. Providing alternative plan designs at lower premium costs or reducing benefits - effective January 1, 2015, the EUTF Board provided a new Medicare Advantage medical plan through UnitedHealthcare (UHC) that provides a lower benefit but at a much reduced monthly premium ($49 per month for a self UHC Medicare Advantage plan versus $193 per month for the HMSA self Medicare supplemental plan). The EUTF Board will continue to investigate the addition of other plans.
4. Addressing rising healthcare costs – the EUTF Board will continue to investigate disease management, wellness and other cost containment programs to address the rising healthcare costs.

Our understanding is that the Rate Stabilization Reserve Fund (RSRF) will receive funds from the following sources:

1. OPEB Trust amounts including investment earnings in excess of $2 billion at the end of each fiscal year.
2. EUTF operating funds in excess of $100 at the end of each fiscal year.
3. Appropriations from the legislature.

Section 2 of the bill states that, "the rate stabilization reserve fund shall provide reserve funding to stabilize the fund when there is insufficient money in the fund to cover the costs of providing health and other benefit plans for employee-beneficiaries and dependent-beneficiaries as required by this chapter."

The following are fundamental flaws of Sections 1, 2, 4 and 5:

1. These sections do not contain any methods mentioned above to address the unfunded liability.
2. The RSRF is unnecessary since 1) the EUTF offers fully insured plans (risk of loss is borne by the insurance carriers) except for the prescription drug plan which is self-insured (risk of loss is borne by the EUTF) and 2) the EUTF maintains reserves ($209 million at January 31, 2015) to fund any shortfalls.
3. Section 5(1)(b) of the bill adds a sentence at the end of the section that in effect repeals the provisions of Act 268 once the OPEB Trust reaches $2 billion by stating, "…no public employer contribution shall be required if the separate accounts for each public employer within the separate trust fund have an aggregate balance of at least $2,000,000,000." Funding of Act 268 is one of the most, if not the most, important way to reduce the unfunded liability. It is likely that credit rating agencies will look very unfavorably on such a "repeal" of Act 268.
4. If the funding mechanism of Act 268 is not in place, GRS may use a lower discount rate to determine the actuarial accrued liability. GRS has calculated the State's actuarial accrued liability to be $13.5 billion as of July 1, 2013 using a 4% discount rate (this is the discount rate used by the EUTF's previous actuary in determining the actuarial accrued liability assuming no pre-funding) which is a $5 billion or a 59% increase.
5. Under the terms of the OPEB Trust and the Internal Revenue Code (IRC), the transfer of investment earnings in excess of $2 billion from the OPEB Trust to the RSRF is not permitted. The terms of the OPEB Trust and the IRC stipulate

that the OPEB funds must be used for the exclusive benefit of providing benefits to the retirees (the exclusive benefit rule). Transfer from the OPEB Trust to the RSRF for use by the active employees is not permitted.

6. It is unclear how having funds in the RSRF is more beneficial than retaining them in the OPEB Trust. The OPEB Trust will have an expected return of 7% if Section 3 of the bill is passed. Based on the stated purpose of the RSRF, it is likely that these funds will be invested for the short term, similar to the current EUTF reserves, resulting in an expected return of closer to 1%. In addition, employers who have funded the OPEB Trust will likely have an incentive to deplete those assets if the investment earnings are transferred into the RSRF.
7. The OPEB Trust is a qualified trust as defined by Governmental Accounting Standards Board Statements No. 43 and 45. As a result, the assets contributed by the employers plus investment earnings are considered when calculating the unfunded actuarial accrued liability. The RSRF proposed will not be considered a qualified trust for funding of the actuarial accrued liability since it can be used for active employees. Therefore, the employers will not be able to show their share of the RSRF, assuming the RSRF is segregated by employer, as funding for the actuarial accrued liability for financial statement purposes. The creation of the RSRF would undermine the employers who have already made sacrifices to fund their OPEB obligations.

Thank you for the opportunity to testify.

LEGISLATIVE TAX BILL SERVICE

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: MISCELLANEOUS, Rate Stabilization Reserve Fund for OPEB

BILL NUMBER: HB 1356, SD-1

INTRODUCED BY: Senate Committee on Judiciary and Labor

EXECUTIVE SUMMARY: This bill deals with other post-employment benefits for state workers – meaning ERS and EUTF. Act 268, SLH 2013, established a mechanism to pay down the unfunded liabilities over time. The bill recites that it can deal with those problems without raising taxes, affecting workers' benefits, or laying off people. The reality, however, is that at its core, the bill tosses away the fiscal discipline of Act 268, instead relying upon a pay-as-you-go mentality. In addition, key pieces of this legislation conflict with federal law and the terms of the existing OPEB trust instruments.

BRIEF SUMMARY: Adds a new section to HRS chapter 87A that establishes a rate stabilization reserve fund. The fund is to provide reserve funding to stabilize the fund when there is insufficient money in the fund to cover the costs of providing health and other benefit plans for employee-beneficiaries and dependent-beneficiaries. Unless otherwise specified by law, the rate stabilization reserve fund shall not be subject to appropriations for any purpose and shall not be subject to claims by creditors of the employers.

Provides that any balance in the employee benefits trust fund under section 87A-31 will be transferred to the new rate stabilization reserve fund.

Deletes the language providing that a public employer's required contribution to the employee benefits trust fund includes an amortization payment that is designed to fund the unfunded actuarial accrued liability over the next thirty years. Adds language stating that no public employer contribution shall be required if the separate accounts for each public employer within the employee benefits trust fund have a combined balance of at least $2 billion.

EFFECTIVE DATE: January 7, 2059

STAFF COMMENTS: The state long ago agreed to pay post-employment benefits to its workers. ERS, or Employees' Retirement System, represents the retirement benefits. EUTF, the Employer-Union Health Benefits Trust Fund, represents the medical benefits. At June 30, 2013, ERS had an "unfunded actuarial accrued liability" of about $8.4 billion. For EUTF, the number was about $18.2 billion. Those numbers represent the present value of what we taxpayers owe for these future benefits. In comparison, the total annual state general fund budget is $5.5 billion.

Faced with these staggering numbers, Act 268, SLH 2013, was enacted. Act 268 requires public employers to pay actuarially determined annual required contributions to fund the present cost of the benefits and to eat away at the unfunded balance over thirty years' time. If the public employers do not pay their required contribution, the general excise tax would be sequestered to pay it if the delinquent employer was the state; if the delinquent employer was one of the counties, that county's share of the

transient accommodations tax would be sequestered. Again, the idea was to pay down the unfunded liability over a period of several years.

The bill proposes to deal with the issue by establishing a new fund to “stabilize” the system when there is insufficient money. The first issue, of course, is figuring out how to fund this fund.

To accomplish this trick, the bill basically proposes to do away with the amortization built into Act 268. “The State and counties cannot afford to pay for both the increasing cost of healthcare premiums as well as the prefunding of the liability,” as stated in the preamble to the bill as introduced, and “most state governments, including Hawaii, currently follow a pay-as-you-go approach, paying an amount each year about equal to the benefits distributed or claimed in that year.” In other words, the bill proposes to deal with the unfunded liabilities problem by denying that it’s a problem. “Don’t worry,” it’s telling everyone. “We can pay the current year’s costs of the post-employment benefit programs we created. There won’t be any rainy day. So just go about your business.”

This might be fine if there is in fact no rainy day, and the economy chugs along giving us enough money to pay these obligations. But if bad things happen – we’ve recently had to face crippling economic recessions as well as natural disasters – then we might deeply regret ever having gone into pay-as-you-go mode.

In addition, one of the central premises behind the proposed stabilization fund is that it won’t be raided, ever. The reality, however, is that nice, fat stabilization funds make for very tempting raid targets. However well-intentioned this legislature is, however, it normally can’t bind a future legislature.

Next, the bill proposes that the stabilization fund be fed by transfers from the existing funds. Nominally such transfers would accomplish nothing, being payments of money from the State’s right pocket to its left pocket, but, as previous testifiers have pointed out, such transfers would violate the trust instrument that establishes the trust funds in the first place, and they would violate the Internal Revenue Code, a federal law that cannot be modified by state law. Such transfers also potentially violate ERISA, a federal law that has been held to have a very broad preemptive sweep. If enacted, then, it seems clear that key pieces of the plan won’t work.

Digested 4/1/15