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October 23, 2017

The Missouri State Employees' Retirement System Board
907 Wildwood Drive
Jefferson City, MO 65109

Submitted via email to mosers@mosers.org

RE: Terminated-Vested Member Buyout Program

Dear Members:

The Pension Practice Council of the American Academy of Actuaries[1] recently became aware of the Terminated-Vested Member Buyout Program adopted as part of Senate Bill 62 (SB 62) and described in Board Rules 2-18 and 3-17 of the Missouri State Employees' Retirement System (MOSERS). As part of its mission to serve the public, the Academy identifies and addresses issues on behalf of the public interest in which actuarial expertise can provide insight or understanding.

We appreciate the need to manage the cost of MOSERS, and recognize that offering members lump sums that are lower than the present value of their annuity benefits has the potential to benefit both the system and the members. We are concerned, however, that MOSERS members may not understand that the methodology used under the buyout program results in lump sums that are substantially lower than would be needed to purchase the forsaken annuity benefits in the private market. In order to help members better understand the implications of whether to choose a lump sum, MOSERS may want to reconsider how lump sum offers under the buyout program are communicated to ensure that members have the information needed to make a fully informed choice.

Our understanding is that SB 62 allows certain terminated-vested members to elect a lump sum in place of their deferred normal retirement annuity. Board Rules 2-18 and 3-17 define the buyout amount as 60 percent of the present value of the member's deferred normal retirement annuity, where the present value is determined using a discount rate of 7.50 percent.

[1] The American Academy of Actuaries is a 19,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

This methodology results in buyout amounts that are far below what would be needed to purchase the deferred normal retirement annuity from an insurance company. The methodology understates the market price in two ways:

- **The 60 percent factor**—This step, by itself, reduces the buyout amount by 40 percent and also reduces the expected cost of MOSERS. While the reduction is clear to the member, no rationale for the reduction factor appears to have been provided to members. Absent an explanation, members could be left to infer the reason for the reduction, which could cause them to question the ability or commitment of MOSERS to pay their annuity benefits in full. Members may not understand that the current funded status of MOSERS is unlikely to cause them to only receive a portion of their deferred annuity.

- **The 7.50 percent discount rate**—The 7.5 percent per annum discount rate appears to be based on the expected return on assets for MOSERS. This basis may be appropriate for budgeting long-term contributions to the system, but is not the basis for a market price of the annuity benefits. In the financial markets, obligations to make regular future payments to other parties are priced using discount rates reflecting yields on fixed income securities of an appropriate credit quality. Barring default, these securities will provide the cash flows needed to make the expected annuity payments. Private sector pension plans offering lump sum payments are required to use discount rates under Internal Revenue Code Section 417(e) that are based on such fixed-income yields. Current 417(e) rates range from about 2 percent to about 4 percent depending on how far in the future the projected annuity payment is. Using a discount rate of 7.5 percent could produce buyout amounts that are less than half of those developed using current fixed income yields. Members are unlikely to understand the significant reduction to the buyout amount caused by the discount rate assumption.

The combination of these two factors results in settlement amounts under the buyout program that are significantly less than the same benefit would be settled for in a corporate pension plan or what the annuity payments are worth in the broader financial markets. If they were to take the buyout amount and attempt to purchase lifetime income benefits, they would not be able to purchase anything remotely comparable to the annuity benefits they had been promised by MOSERS. Some members may understand these considerations and choose the lump sum anyway (perhaps due to specific individual circumstances), but many of those who accept lump sum amounts under this program are likely to not understand the financial value of their annuity benefits.

A full and thorough disclosure about the buyout amounts would help members understand the current financial value of the annuity payments they are relinquishing. Section 9 of the Board Rules indicates that each eligible member will be provided with "(a) an estimate comparing the amount of the projected buyout payment under the Buyout Program with the monthly amount of the member's projected normal retirement annuity; and (b) a description of the actuarial assumptions used in the calculation."

We believe it will be difficult for members to compare a single lump sum to a monthly amount that continues for the member's life with annual cost-of-living adjustments. This difficulty could be addressed by expanding the disclosure to also include comparisons to what it would cost to replace the forgone annuity pension benefits in the financial markets. These amounts could be approximated using the applicable assumptions for private sector plans under Internal Revenue Service (IRS) regulations or by other methods that reflect the yields on current fixed income securities of an appropriate credit quality. This disclosure would help to ensure that members understand any shortfall that exists between the buyout amounts they are being offered and the generally accepted financial value of the annuity benefits they would be giving up. In the absence of such a disclosure, some of the cost savings achieved by the program may be due to members not fully understanding the financial value they are sacrificing.

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We appreciate your consideration of our comments related to the communication of buyout amounts under the MOSERS Buyout Program. If you have any questions or need further information, please contact Monica Konaté, pension policy analyst (konaté@actuary.org; 202-223-8196).

Sincerely,

William R. Hallmark, MAAA, ASA, EA, FCA
Chairperson, Pension Practice Council
American Academy of Actuaries