State of South Carolina

Office of the Governor

MARK SANFORD
GOVERNOR

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April 10, 2008

The Honorable Converse Chellis
South Carolina Treasurer
Post Office Box 11778
Columbia, South Carolina 29211

Dear Converse,

Thank you for your recent response on my concerns regarding H. 4673 and S. 1124. I certainly appreciate your comments and believe that the Socratic Method is helpful in getting to the right solutions. As an aside, I wish you had taken the time to respond in this level of detail, or even respond at all, when I raised concerns to you via multiple letters several months ago about some of your votes on the Budget and Control Board.

As to the process questions you outlined, the layman's response would be something along the lines of "give me a break" or "you have got to be kidding me" as the totality of where this administration has stood on finance questions has consistently been, "Don't spend what you don't have." It is a concept well understood in households and businesses across our state, but for some reason lost on far too many in Columbia.

The concepts here are remarkably simple. We don't think it makes sense to add another $2.6 billion in potential debt to more than $20 billion of existing unfunded political promises, and we also think it is a mistake to boost expected returns as the way of justifying more spending. In the real world, if you chose to assume a higher return in your savings account – though this return would be greater than someone just like you in North Carolina or Georgia, or for that matter the average of all states – simply for yet more spending rather than paying down the mortgage you couldn't afford, people would say you were financially reckless. That is precisely our state's situation and why we think it would be so important for you to advocate paying down our unfunded liability rather than adding to it.

More officially, I'd say that the position of this administration on the state's retirement system being unclear to you or anyone else is completely baffling since we have been stating and restating our case since I took office in 2003. While your tenure as Treasurer has been short, you have certainly been a part of the debate for some time as a member of the House. I am certain you recognized many of the concerns I laid out in my last letter from the greater discussion on the state's retirement system from my annual Executive Budget. Though you have not been directly involved in our annual budget presentations, I have also laid out thoughts about the retirement system annually when the Budget and Control Board discusses and has granted, an *ad hoc* cost of living adjustment (COLA) over my objection and that of the Comptroller General. Finally, I refer you to my communication with the General Assembly in June 2005 when I signed S. 618 calling for a more comprehensive retirement reform package and addressing the annual COLA specifically.

The concerns I laid out in my last letter, as well as the concerns I lay out in this letter, do not address your Task Force's very narrow mission of the unfunded liability of the state's retirement system. That liability must be placed in the context of the total liabilities of the state and the economic and budgetary conditions we are currently facing. As much as we appreciate the work of your Task Force, my fiduciary responsibilities are not to the work of your committee, but to the taxpayers of the state. With that in mind, I would like to address a couple of areas that I take particular issue with and show where these proposals will fall short in meeting commitments to current and future retirees.

First, the overall liability of retirement benefits should not simply be parsed apart for purposes of convenience. Let's be clear, that $20 billion unfunded liability represents a debt that is almost three times the size of the state's budget. If traditionally granted cost of living adjustments are factored in, that liability jumps to $27 billion. Such an enormous unfunded liability should not be diminished simply because it was not in the context of your Task Force's mission. Even with the enactment of H. 3789, we believe that both the OPEB liability and the unfunded liability of the state retirement system need to be more adequately addressed.

Second, the eight percent investment return assumption is out of line with that of other states *facing the same retirement issues* we face. When taking into account inflation, the real rate of return equates to five percent – which is in fact a higher assumption than the national average of other retirement systems and that of our neighboring states. South Carolina's optimistic numbers are provided below by the actuary group *Milliman*.

COMPARISON WITH OTHER RETIREMENT SYSTEMS

State	Investment Return Assumption	Inflation Assumption	Assumed Real Rate of Return
North Carolina	7.25%	3.75%	**3.50%**
Georgia	7.50%	3.75%	**3.75%**
SC - current	7.25%	3.00%	**4.25%**
National Median	8.00%	3.50%	**4.50%**
SC – proposed (H4673 and S1124)	8.00%	3.00%	**5.00%**

Simply calculating the above numbers show that these bills estimate a real rate of return that is 11 percent higher than the national median for public funds, 33 percent higher than Georgia's retirement system, and 43 percent higher than North Carolina's retirement system.

With regard to the COLA component itself, I think this legislation falls short on two very significant fronts. First, it disregards history at a reduced present cost to the system. We have been very clear that there needs to be complete transparency in the retirement system – and that includes building in the total cost of the COLA to the retirement system. The legislation doubles the COLA assumption from one percent to two percent – while history shows that the average COLA has been approximately three percent. As you should recall, S. 618 of 2005 enacted the guaranteed one percent COLA, but left open the option of a further COLA increase on an *ad hoc* basis by the Budget and Control Board. As a result, the companion bills either locks in future COLA's at two percent annually or continues the practice of underestimating the annual *ad hoc* COLA that will almost certainly be approved by the Budget and Control Board. That undervaluing could be addressed in the short term if you and the legislative members of the Budget and Control Board were committed to only supporting the funded guaranteed COLA in the coming years.

Second, even if it is a cost neutral proposal as you suggest, and with which I disagree, the prioritization is misplaced. Rather than dedicating the reduced liability to building up the COLA, we believe the first order of business should be to reduce the overall liability. As much as retirees care about COLA as a way of guarding their returns from inflation, they care even more that government will honor its commitment to the viability of the system itself – because without it there is no payment onto which a COLA can be added.

According to your estimate, the unfunded liability of the State Retirement System is still 18 months shy of the 30 year cap. As I predicted when the General Assembly enacted S. 618 in 2005, the unfunded liability would be back close to the cap in just a few short years. Fast forward to today, roughly six years has been added to the unfunded liability since that bill was passed. I think another short term fix that does nothing to address the long-term liability ought to be considered unacceptable.

If it would help in this discussion, our office will gladly provide copies of Executive Budgets, press releases, State of the State addresses, and other forms of more personal correspondence in which we've expressed our concerns over unfunded liabilities in the retirement system, as well as the accompanying COLA issue.

H. 4673 and S. 1124 should not be built around the notion of simply finding ways to guarantee another one percent annual COLA. Doing so in present form would bring injury both to retirees and taxpayers funding the system. We would welcome the chance to further explore ways to address the overall unfunded liability of the retirement system in ways that avoid what may be politically expedient – but in the long run detrimental to a system so many rely on in our state.

Again, I thank you for your comments and take care.

Sincerely,

Mark Sanford

MS/se

Cc: Members of the General Assembly
Members of the COLA Task Force