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Understanding Pensions

A Primer on Public Employee Pension Plans

BGR PENSION SERIES ■ PART I

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Peter Reichard, *Projects Manager*
Ryan Galvin, *Research Analyst*
Kevin Murphy, *Research Analyst*
Stephen Stuart, *Research Analyst*

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BUREAU OF GOVERNMENTAL RESEARCH
938 Lafayette St., Suite 200
New Orleans, LA 70113
Phone 504-525-4152
Fax 504-525-4153
www.bgr.org

BGR Board of Directors

Publication Design: Peter Reichard

INTRODUCTION

When it rains, it pours. During the past decade, retirement funds for state and local government workers have experienced a severe reversal of fortune. Having fallen from the heights of booming stock market investment earnings, many of these funds have suffered significant losses and seen their unfunded liabilities skyrocket. The losses have struck at a time when governments are struggling with other recession-related fiscal challenges. As a result, many state and local governments must dedicate increasing portions of their already-strapped budgets to pay for benefits promised long ago. In some cases, public services are being cut in order to fulfill those promises.[1]

Now many state and local governments, and the taxpayers who support them, are questioning the affordability of their retirement plans for public employees. Since 2009P, 43 states, including Louisiana, have enacted revisions to retirement plans.[2] While many reforms tinker at the margins of existing plans, a few state and local governments have implemented more drastic measures that revamp retirement benefits for public employees.

Louisiana has taken a number of steps over the last 25 years to address the fiscal condition of pension systems in the state. This year alone, the Louisiana Legislature has before it nearly 30 bills that attempt to rein in costs. Some would change the fundamental nature of public sector retirement plans, replacing guaranteed lifetime benefits with more limited obligations. Others would reel in benefits by adjusting the multiple factors that affect the levels of employee benefits. Still others would increase the amounts that employees are required to contribute to their retirement plans.

The implications of the proposed changes are difficult to assess without an understanding of how pension systems work. In this report, BGR provides a primer on the subject.

This report is the first of a series on public pension plans in which local governments in Jefferson, Orleans and St. Tammany parishes participate. In upcoming reports, BGR will review the health, benefits and associated costs of those plans and compare them against national norms. BGR will also explore public pension reform options.

BACKGROUND

The Role of Public Pension Plans

Clearly, the main purpose of a pension plan is to provide employees with a regular source of income and financial security in retirement. There are, however, a number of other reasons that governments provide their employees with pensions. Among other things, they help governments attract and retain employees.

A related and commonly cited reason for public pensions is that they make government competitive with the private sector by offsetting a salary differential between the two. The extent of that differential, and whether a guaranteed retirement benefit is the way to offset it, is the subject of debate. This report does not attempt to resolve the issue.

Types of Retirement Plans

There are two major types of retirement plans: defined benefit plans and defined contribution plans.

A *defined benefit plan* provides workers with a guaranteed benefit throughout retirement. Benefits are generally based on years of service and a percentage of pay. In the public sector, plans are funded through employer contributions, investment earnings and, usually, employee contributions. In Louisiana, some plans receive revenue from dedicated taxes and other public sources. If the amounts contributed to the plan over the length of an employee's employment, combined with the plan's investment earnings, are insufficient to pay for the promised benefit, the employer is obligated to pay the difference.

A *defined contribution plan* provides retirement benefits through an individual retirement savings account funded by the employer, the employee or both. The funds in the account are invested, typically at the direction of the worker, based on options established by the employer.

The extent of the employer's commitment varies. Some employers commit to contribute a percentage of an employee's salary or to match a portion of an employee's contributions. Others tie their contributions to profits or make them on a discretionary basis.[3]

With a defined contribution plan, the employee is not guaranteed a specific benefit throughout retirement. He receives only the value of his account – contributions made over the course of his participation plus or mi-

DEFINED BENEFIT VS. DEFINED CONTRIBUTION PLANS

There are several noteworthy differences between defined benefit and defined contribution plans.

Investment Risk. With defined benefit plans, employees know they will receive a fixed amount of income based on a pre-determined formula for the length of their retirement. The amount they receive does not change based on a plan's investment gains or losses. The employer is responsible for covering any shortfalls between the cost of promised benefits and available funding. With defined contribution plans, employees receive whatever amount of money is in their account when they retire. The amount in the account varies based on the gains and losses that result from the investment of the funds in it.

Longevity Risk. Longevity risk is the risk that employees will live longer than expected. In a defined benefit plan, this risk falls on the employer. In a defined contribution plan, an employee bears the longevity risk.

Predictability of Costs for the Employer. With defined benefit plans, an employer's annual contribution typically varies based on a number of factors, including investment returns and estimates of future liabilities. Annual contributions to defined contribution plans, on the other hand, are limited to specified percentages of employee salaries or employee contributions, making them more predictable.

Decision-Making Power. When it comes to defined contribution plans, employees must make a number of choices that are unnecessary in the case of defined benefit plans. These relate to participation and the investment of their assets.

Employee participation in defined benefit plans is typically mandatory. In contrast, participation in defined contribution plans is often optional. As a result, some employees pass up the opportunity to participate in the only retirement plan available to them.

Investment decisions for defined benefit plans are made by fiduciaries for the plans, rather than plan participants. Employees participating in defined contribution plans have some discretion as to how their accounts are invested. The investment discretion can create problems, since many employees lack the time, skills and expertise needed to assess their investment options.

Portability. Retirement benefits provided through defined contribution plans are more portable than those provided through defined benefit plans. In the case of a defined benefit plan, a departing employee who has not yet vested receives only his contributions and, in some cases, interest on them. He forfeits the contributions made by the employer on his behalf and any claim to future benefits. In the case of a defined contribution plan, an employee moving to a new employer can take along his contributions, employer contributions (subject in some cases to a short vesting period) and any earnings or gains.

nus investment gains or losses. The employer's obligation is limited to the amount it committed to contribute. Examples of defined contribution plans are 401(k) and 403(b) plans.

A small number of public employers offer hybrid plans that combine elements of defined benefit and defined contribution plans. Most hybrid plans in the public sector combine a reduced defined benefit plan with an individual defined contribution retirement savings account. BGR found a couple of examples of cash balance plans offered by the public sector.[4] In a cash balance plan, an employer commits to contribute a certain amount to a common fund and to pay interest at a rate determined by formula. The employer guarantees a minimum return.

Defined benefit plans were the norm in both the public and private sectors well into the 1980s. In the mid-1980s, 93% of full-time state and local government workers and 76% of private industry workers participated in defined benefit plans.[5] Over the next 25 years, the availability of defined benefit plans declined drastically in the private sector, but only modestly in the public sector. By 2011, 84% of state and local government workers had access to a defined benefit plan, whereas only 20% of private sector employees did. In contrast, approximately 30% of government workers and 58% of private sector workers had access to a defined contribution plan.[6] Some workers had access to both types of plans.[7]

Multiple factors contributed to the shift in the private sector. They include the growth of the service industry, and the accompanying changes in the composition of the work force and in employment relationships. Laws enacted in the 1970s and the 1980s also played a role. The Employee Retirement Income Security Act (ERISA) made it more complex and costly for the private sector to offer defined benefit plans. Tax code revisions allowing employees to contribute to defined contribution plans on a pre-tax basis increased the attractiveness of such plans.[8] The then-booming stock market also helped make defined contribution plans attractive to potential employees.

DEFINED BENEFIT PLANS IN LOUISIANA

As is the case nationwide, the vast majority of state and local government employees in Louisiana participate in defined benefit plans. The plans are offered by retirement systems established by the State Legislature or local governments.

In Louisiana, there are three basic groups of retirement systems: “state” systems, “statewide” systems and local systems.[9] All of the 13 state and statewide systems offer defined benefit plans; one of them also offers a defined contribution option for a subset of participants, university employees. The local systems include both defined benefit and defined contribution plans.

The four state systems are the State Police Pension and Retirement System, the Louisiana State Employees’ Retirement System, the Teachers’ Retirement System of Louisiana, and the Louisiana School Employees’ Retirement System. As their names imply, these systems cover the state police, other employees and officials of the State and its agencies, teachers, and other employees of the public educational system. The first two systems are single-employer systems, and the other two are multi-employer ones.

The nine statewide systems cover assessors, clerks of court, district attorneys, firefighters, municipal employees, municipal police employees, parish employees, registrars of voters and sheriffs.[10]

Examples of local systems include the Employees’ Retirement System of the Sewerage & Water Board, the Firefighters’ Pension & Relief Fund of the City of New Orleans, and the City of New Orleans Employees’ Retirement System.

The state guarantees benefits payable by the four state retirement systems.[11] It does not guarantee the benefits payable by statewide or local plans.

CALCULATING BENEFITS

Under a defined benefit plan, an employee becomes entitled to a benefit in the form of an annuity. A number of factors enter into the calculation of the benefit payable under a defined benefit plan. They include: the final average salary, the benefit multiplier, and the number of years of credited service. Basically, to determine the retirement benefit, the final average salary is multiplied by the applicable multiplier and the years of service:

Benefit = Final Average Salary
x Multiplier x Years of Service.

Take for instance, an employee whose salary averaged $50,000 during the last three years of service, after a 30-year career. At a 2% multiplier, that employee’s annual compensation in retirement would total $30,000, or 60% of the average final compensation.

Other factors discussed below, such as cost-of-living allowances and replacement caps, can result in adjustments to the amount of the benefit.

Final Average Salary

Most public defined benefit plans calculate benefits based on an employee’s average earnings over some specified period of time. The calculation uses the years in which an employee’s salary was highest. The length of the period, which is known as the final average compensation period, differs among retirement systems.

Nationwide, 56% of state and local government workers participating in defined benefit plans have a three-year final average compensation period; 22% have a five-year period and six percent have a one-year period.[12] Shorter compensation periods generally translate into higher retirement benefits than longer ones, because longer periods pick up a wider range of an employee's earnings.

Benefit Multiplier

The benefit multiplier is another factor affecting the size of employees' retirement benefits. The higher the multiplier, the greater the amount of the retirement benefit that accrues in a year.

A small increase in the multiplier can result in a significant increase in the retirement benefit. For example, raising a multiplier from 1.5% to 1.65% produces a 10% increase in retirement benefits.[13]

Most defined benefit plans for public employees apply a single benefit multiplier to all of an employee's years of service. In some plans, however, the multiplier varies based on years of service or earnings. Higher multipliers for later years of service can be an incentive for employees to work longer.

There are wide variations in the size of multipliers and a number of factors that account for some, but not all, differences. Plans for public safety employees tend to have a higher multiplier. That's because the work life of those employees is considered shorter than usual, due to the hazards and physical demands of their employment.[14]

All things being equal, a plan for public employees not covered by Social Security should have a higher multiplier than a plan for covered employees.[15] That's because neither the employer nor its employees is contributing to an employee's retirement through Social Security taxes, and employees will not be receiving Social Security payments in retirement. Nationwide, the median benefit multiplier for public employees not covered by Social Security is 2.2%. The median benefit multiplier for employees covered by Social Security is 1.85%.[16] In Louisiana, almost all state and local government employees are outside the Social Security system.[17]

Years of Service

Calculating the years of service for which an employee receives credit is a fairly simple concept. However, there are a couple of variations among plans. First, some plans allow an employee to receive credit for unused vacation and sick pay or to purchase years of service based on prior employment with the plan sponsor or another government entity. Second, in some cases work for another government employer can be credited.

The basic formula for calculating benefits is subject to adjustment. In some cases, the retirement benefit is limited by caps. In others, it is adjusted upward in response to inflationary pressures.

Caps

Some defined benefit plans cap replacement rates or benefit amounts for employees. For example, the highest retirement benefit that an employee can earn annually may be capped at 80% of his final average compensation. Alternatively, the annual maximum may be a dollar value, such as $100,000. The lower the maximum replacement rate or benefit amount, the lower the public cost of benefits.

A plan's benefit multiplier affects when an employee is able to reach the maximum replacement rate. The higher the multiplier, the sooner the employee reaches the maximum. For example, if the multiplier is 3.5%, an employee reaches a 100% replacement rate after 28.6 years of service. With a 2% multiplier, an employee will reach a 100% replacement rate after 50 years.

Cost-of-Living Adjustments

Cost-of-living adjustments (COLAs) are annual additions to an employee's retirement benefit to offset inflation. COLAs may be awarded automatically each year based on a set amount or by an amount pegged to some measure of inflation. Alternatively, COLAs may be awarded only in certain circumstances, such as when investment earnings exceed expectations by a certain percentage.

How a public defined benefit plan awards and accounts for COLAs for retirees affects the ultimate level of benefits it provides and the cost of the plan. If COLAs have not previously been taken into account in calculations of future liabilities, they increase the future cost of the plan.

ASSESSING THE ADEQUACY OF BENEFITS

In an ideal world, retirees would have adequate income to maintain a quality of life similar to what they enjoyed while working. Due to lower expenses in retirement, the amount of income required to achieve that goal is usually lower than an employee's pre-retirement income. Estimates range widely, from 70% to 94% of pre-retirement income, and vary according to income level.[18]

Generally, employees have three possible sources of income to meet post-retirement expenses: Social Security, personal savings and pension benefits. There are, however, significant differences as to the availability of the sources for private and public sector employees.

Most private sector employees do not have guaranteed pension benefits, while most public sector employees do. The situation is reversed when it comes to Social Security benefits. All private sector employees are required to participate in that program. In the public sector, however, participation is at the option of the state and local government. Nearly 25% of government employees in the U.S., including almost all public sector employees in Louisiana, are not covered.[19] The non-covered employees are more heavily dependent than others on their pension plans and personal savings, and those sources have to cover a larger portion of their retirement income.

The adequacy of pension benefits is often measured by the plan's replacement rate. The replacement rate is the percentage of an employee's salary that a plan will provide upon normal retirement. It should correlate in some rational way with the percentage of pre-retirement salary needed to maintain an employee's quality of life.

In states where public sector employees participate in Social Security, government pension plans replaced on average 58% of the pre-retirement salary of a 30-year employee retiring in 2006. The average replacement rate for a similar public sector employee in states that do not participate in Social Security was 73%.[20]

ELIGIBILITY REQUIREMENTS

There are a couple of important milestones on the road to a pension. The first is the date on which an employee participating in a plan becomes entitled to future benefits. The second is the date on which an employee becomes eligible to start collecting retirement benefits.

Minimum Service

To be eligible to receive retirement benefits from a defined benefit plan in the future, an employee must have worked for a specific period of time. A recent study of public retirement systems found that time periods typically range from three to 10 years. The median period is five years of service.[21] An employee who leaves before meeting the minimum service requirement is not eligible to receive benefits that were accruing prior to his departure. He receives only the amount that he contributed to the plan, plus interest in some cases.

Retirement Eligibility

To begin collecting benefits, an employee must meet stipulated eligibility requirements based on length of service or a combination of age and length of service. An example of a requirement based on length of service is 30 years of service, regardless of age. An example of an eligibility requirement that combines years of service and age is 12 years of service at age 55. Another is 10 years of service at age 60.

Most plans offer a number of options for reaching eligibility. By way of example, a plan might allow retirement at 25 years service at any age, 20 years of service at age 50, or 12 years of service at age 55.[22] Typically, the older an employee is, the fewer the years he needs to have worked to be eligible to retire. This can act as an incentive for older, more experienced workers to join the public sector, even if only for a few years. On the flip side, it can result in a long-term public cost in return for relatively little service.

Nationwide, 56% of state and local workers participating in a defined benefit plan face a fixed age threshold in all of their eligibility options. Another 25% of these workers can retire based on years of service alone. The remainder use any combination of age and years that total a certain number, such as 80.[23] The age thresholds are typically lower than the threshold for Social Security and the normal retirement age for private sector employees.

Public sector employees can generally retire and receive benefits at an earlier age than private sector employees. A 2010 study of state employee and teacher retirement plans nationwide found that 83 of 87 plans allowed employees who met specified service requirements to retire with full benefits on or before age 62.[24] The age for receiving full Social Security benefits is 66 for employees born after 1943. It rises to 67 for employees born after 1959.

A higher retirement age can promote the fiscal health of a pension system in two ways: Employees generally contribute to the fund for a longer period of time, and they receive retirement funds for a shorter period of time.

DROP

Some public sector pension plans offer a deferred retirement option plan, known as DROP, for employees who have met a plan's retirement eligibility requirements. An employee participating in DROP continues to work for an employer and collect his salary. The pension payments that he would have received had he retired are credited to an account during his continued employment, and paid to him upon retirement. Depending on the plan, the employee may be entitled to interest on funds in the DROP account. In essence, the employee is receiving two work-related payments from his employer: a direct one in the form of salary and a delayed one from the employer's pension system.

The amount of the DROP participant's retirement benefit is set as of the date that he enters DROP. Generally, he does not make additional contributions to the pension system or accrue additional benefits during the DROP period.[25]

DROP offsets the incentive to early retirement created by many pension plans. It was conceived as a way to encourage productive and knowledgeable employees who would otherwise retire to continue working. It is not restricted, however, to such employees. Any employee who meets the eligibility requirements for retirement can take advantage of DROP.

FUNDING PENSION PLANS

Pension plans can be funded on a pay-as-you-go or a prefunded basis. Almost all pension plans, including those in Louisiana, are prefunded. This means that obligations to make payments in the future are supposed to be recognized as they are incurred, and assets set aside to meet them. However, few are fully funded. See the discussion on page 7.

Public defined benefit plans are typically funded through three sources: investment income, employee contributions and employer contributions. In some cases, plans may receive additional contributions in the form of dedicated taxes or other public revenue.

Investment Income

Before the 1980s, many states restricted the portion of assets that public retirement plans could invest in various securities.[26] A common restriction limited the percentage of assets held in common stock to 35% or less. In the 1980s, state legislatures allowed many public plans to use the "prudent person" rule to govern investments. This rule generally allows plan fiduciaries to invest with the judgment and care that a prudent, intelligent investor would exercise in his own affairs to achieve a reasonable return while preserving capital.[27] In effect, the rule permitted public retirement plans to invest a larger percentage of assets in equities. Equity holdings have since risen to more than 50% in many plans, and investment income is by far the primary source of plan funding today.[28]

Investing significant portions of assets in equities can reduce the public cost of providing retirement benefits when investment earnings meet or exceed expectations. But it also increases a plan's exposure to risk and the potential for volatility in an employer's annual required contribution rate.

Employee Contributions

In the public sector, most employees (77%) are required to contribute to defined benefit plans.[29] Employee contribution rates, usually set at a fixed percentage of salary by law or plan rule, remain fairly constant over time.[30] The more employees contribute to the cost of their retirement benefits, the lower the cost to employers and the public.

Nationwide, the average contribution rate was 6.3% of earnings in 2008.[31] However, the rate varies significantly depending on whether the employees also participate in Social Security. If employees do not participate (as is the case for almost all state and local government employees in Louisiana), the rate averages approximately 9%. It is approximately 5% for employees who do participate in Social Security.[32]

Contributions of Taxes and Other Revenue

In a handful of states, some public pension plans receive contributions of dedicated taxes or other public revenues.[33] This practice is fairly common in Louisiana.

Employer Contributions

Employers are required to provide the balance of the funding for a plan. This is because the employers have the ultimate responsibility to fund the payment of the plan's defined benefits.

An actuary determines the employers' annual required contribution, usually expressed as a percentage of projected payroll, through a complex process known as an actuarial valuation. It requires two important calculations: the present value of future pension benefits and the actuarial value of assets available to pay future benefits.[34]

Using a set of demographic and economic assumptions, the actuary determines the present value of future benefits for current and former employees, retirees and their beneficiaries. The demographic assumptions are used to project the extent to which the plan's members will draw benefits. The actuary projects, among other factors, the rates of mortality, disability and employee turnover, as well as the probability of retirement at various ages. On the economic side, the actuary's projections include the rates of investment return, inflation and employee salary increases.[35]

The rate of investment return, which reflects anticipated long-term investment gains, is an especially important assumption. It is used as the discount rate to arrive at the present value of future benefits. Many public pension plans assume a rate of return in the range of 7.25 to 8.5%.[36] The higher the assumed rate of return, the lower the present value of future benefits and, in turn, the required employer contribution.[37]

Having calculated future benefit liability, the actuary subtracts the actuarial value of plan assets and future employee contributions. To calculate the actuarial value of plan assets, the actuary adjusts the market value of the assets at the valuation date to "smooth" the effect of recent gains or losses relative to the assumed rate of return. The typical smoothing period is three to five years.[38] The smoothing process reduces the volatility of employers' required contributions.

The employer is responsible for the balance that remains after subtracting the actuarial value of assets and future employee contributions from the present value of future benefits. The actuary determines how much of that liability must be paid in the upcoming year to meet pension costs accruing in that year and to cover a portion of any unfunded accrued liabilities. Dedicated taxes and other revenues for the upcoming year are applied to reduce the employer's required contribution.

If the employers contribute the required amount and plan assumptions, such as the rate of investment return, hold true, then the plan is able to keep up with its accruing obligations and cover a portion of any unfunded accrued liabilities. If contributions fall short or the assumptions are overly optimistic, the funding burden increases in future years.

GAUGING THE HEALTH OF A PLAN

When plans are funded at healthy levels, they are more likely to be sustainable in the long term. When plans are struggling financially, participating employers and lawmakers may need to rethink the level and type of benefits.

Perhaps the best way to assess a retirement plan's financial health is by the ratio of the actuarial value of its assets to its actuarial accrued liabilities. This is known as the funding ratio. The actuarial accrued liability is the future benefits attributable to past service by current and former employees and retirees.

When a plan has enough assets to cover all of its accrued liabilities, it is considered 100% funded. This does not mean that further contributions are no longer required, but rather that the plan is funded at the appropriate level on the date of valuation. The U.S. Government Accountability Office considers a funding ratio of 80% or above to be sound for state and local public pension plans.[39]

In the 1980s, lawmakers raised concerns that state and local pension plans had not accumulated sufficient assets to meet their liabilities. Some states, including Louisiana, undertook significant reforms to improve the funding of their systems. Pension plans then entered a period of robust stock market performance in the 1990s and substantially improved their funding ratios, reaching 100% on average by 2000. Some plans, overfunded by significant margins, offered more generous pension benefits and reduced contribution rates.[40]

The good times, however, did not last long. Stock market declines in the early 2000s and again in the past few years have weakened the financial position of many plans.[41] The average funding ratio for large state retirement systems, for example, dropped from 100% in 2001 to 86% in 2005 and again to 77% in 2010.[42] A similar decline occurred in locally administered pension plans.[43]

The erosion of plan funding ratios has caused some alarm and prompted calls for re-examining how public pension benefits are provided and funded.

LOOKING AHEAD

In its next report on government pensions, BGR will examine the benefits, funding and public costs of state and statewide plans in which governments in Jefferson, Orleans and St. Tammany parishes participate. Among other things, the report will include an analysis of the factors that affect the generosity and cost of benefits, and benchmark them against national averages.

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BUREAU OF GOVERNMENTAL RESEARCH
938 Lafayette St., Suite 200
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