RIPEC

Comments on Your Government

A SPECIAL PUBLICATION OF THE RHODE ISLAND PUBLIC EXPENDITURE COUNCIL

State and Local Government Pensions and Other Post Employment Benefits

State and local governments are facing financial stresses. One of the primary budget drivers is personnel costs. One of the most significant drivers of these costs is employee benefits, such as health care and pensions. Given this, there has been increased attention on the variables driving personnel costs. To put it in context, this RIPEC Comments is intended to provide a summary of the State's Employee Retirement System, municipal pensions covered in the Municipal Employee Pension System, locally-administered plans, retiree health care, and to outline strategies to curb future costs to taxpayers while providing appropriate benefits to the State's and municipal workforce.

In the Governor's proposed FY 2011 budget, all funds personnel expenditures amounted to approximately $1.7 billion, an increase of 43.2 percent since FY 2001. The fastest growing component of total personnel expenditures during this time has been retirement costs. Over the ten-year period, expenditures on retirement have increased 124.6 percent, from $60.7 million in FY 2001 to $136.3 million in FY 2011. In FY 2001, retirement costs accounted for 5.2 percent of personnel expenditures. This share has increased to 8.1 percent in FY 2011. Medical costs have also increased at a significant rate since FY 2001, growing by 50.9 percent. Together, these two categories account for approximately one quarter of the growth between FY 2001 and FY 2011. One should note that the State's share for the teacher retirement is not included in these expenditures.

Given the fiscal crisis facing State and local governments, coupled with dampened market performance, and demographic factors such as longer life expectancies, there is a need to reexamine and reform the pension systems across the State and municipalities in order to keep pension contributions affordable. If the State and municipalities do not take further action to control the ever-growing cost of pension systems, there will be fewer resources available to support current programs and services offered by the State and cities and towns to its residents.

The State and municipalities have several different ways to improve their retirement systems, including keeping up with funding requirements, changing the benefit structure, sharing risk with employees, increasing employee contributions, and reevaluating actuarial assumptions. In addition, municipalities should evaluate merging their self-administered plans into the MERS if savings can be achieved.

Furthermore, the State and local governments have a number of ways to address the Other Post Employment Benefits (OPEB) liability, including reducing the liability by changing the benefit plan or employee contributions, eliminating or limiting coverage, or establishing a statewide trust for the purpose of holding, investing, and distributing assets to fund employee benefits.

March 15, 2010

Summary of Key Findings

The following sections provide a summary of the State's Employee Retirement System for State employees and teachers, municipal pensions covered in the Municipal Employee Pension System, locally-administered plans, and State and local retiree health care. The Appendix shows OPEB liabilities for municipalities, based on the Auditor General's report "Status of Pension and OPEB Plans Administered by Rhode Island Communities", March 2010.

State and Local Pension and OPEB Liabilities

The unfunded liability for both State and local government pensions and OPEB combined amounts to $9.4 billion. The State's liability accounts for 36.4 percent of the total liability, whereas local government's liability accounts for 63.6 percent.

State/Local Pension and OPEB Liabilities
$ million

	ARC	Payments	Unfunded Liability	Funding Ratio**
State				
Pensions				
State Employees	$127.1	$127.1	$1,671.5	61.8%
Teachers-State Share	79.2	79.2	1,064.2	60.3%
Subtotal Pensions	*$206.3*	*$206.3*	*$2,735.7*	
OPEB*	$36.1	$35.5	$689.7	0.0%
Total State	**$241.8**	**$241.8**	**$3,425.4**	
Municipal Government				
Pensions				
MERS	$33.4	$33.4	$91.7	92.8%
Locally-administered	161.5	132.4	1,894.6	42.8%
Teachers-Local Share	105.2	105.2	1,596.3	60.3%
Subtotal Pensions	*$300.1*	*$271.0*	*$3,582.6*	
OPEB	$189.6	$100.8	$2,392.7	0.7%
Total Municipal	**$489.7**	**$371.8**	**$5,975.3**	
Total State and Local Liability/Payment	**$731.5**	**$613.6**	**$9,400.7**	
State %	**33.1%**	**39.4%**	**36.4%**	
Local %	**66.9%**	**60.6%**	**63.6%**	

ARC= Annually required contribution
*Includes State employees and teachers
**The funding ratios for the State's pension system including MERS is as of June 30, 2008; for locally-administered pension plans as of the most recent information included in FY 2009 audits; the State's OPEB as of June 30, 2007;and local OPEB at June 30, 2009
Sources: ERS/MERS as of June 30, 2008; GRS OPEB Valuation February 2009, as of June 30, 2007; Auditor General report "Status on Pension and OPEB Plans Administered by RI Municipalities", March 2010

State Government

- The State has made its annually required contribution (ARC) payment into the pension system, amounting to $206.3 million for State employees and the State's share for teachers in FY 2009. In the proposed FY 2011 budget, the State's annual required contribution for State employees and teachers amounts to $218.0 million.
- The State's unfunded liability for pensions (State employees and teachers) is $2.7 billion. If the unfunded liability for OPEB of $689.7 million is included, the total State's liability for pensions and OPEB amounts to $3.4 billion. One should note that the valuation for the State's pension system is as of June 30, 2008 and for OPEB as of June 30, 2007.
- The Governor recommends in his FY 2011 proposed budget to fund retiree health benefits based on an actuarial method rather than the current "pay-as-you-go" method. The FY 2011 rate reflects the actuarial basis for current benefits to retirees as well as covering costs associated with the 30-year amortization of the unfunded accrued actuarial liability (UAAL). The proposal places this amount in a separately administered trust fund.

Local Government

- Municipal pension plans covered in the Municipal Employee Retirement System have made their ARC payment into the pension system, amounting to $33.4 million in FY 2009. The unfunded liability for MERS is $91.7 million, with a funding ratio of 92.8 percent (as of June 30, 2008).
- Locally-administered pension plans had an ARC payment of $161.5 million, whereas actual payments were $132.4 million. The unfunded liability for locally-administered pension plans is $1.9 billion, with a funding ratio of 42.8 percent (as of the most recent audit reports).
- The municipal government unfunded liability for OPEB is approximately $2.4 billion (as of the most recent audit reports).
- The total municipal unfunded liability (including pensions and OPEB) is $6.0 billion.

Investment Rate of Return History
Actual Rate of Return

Year Ending June 30,	ERS/MERS	Locally-Ad. Average
2005	11.4%	6.3%
2006	11.6%	7.5%
2007	18.2%	14.0%
2008	-5.8%	-3.8%
2009	-19.2%	-14.2%
Average Returns and Average Assumed Rates		
Last 5 years	3.20%	1.94%
Assumed Rate	8.25%	7.93%
Difference	-5.05%	-5.99%

SOURCE: ERSRI; Actuarial Valuation Report for Fiscal Year Ending June 30, 2008
Auditor General's report "Status of Pension and OPEB Plans Administered by RI Municipalities", March 2010.

- The investment rate of return for the State's Employee Retirement System, including MERS, decreased from 11.4 percent in 2005 to -19.2 percent in 2009. The average five-year rate of return was 3.2 percent, whereas the assumed rate was 8.25 percent.
- The locally-administered pension plans investment rate decreased from 6.3 percent in 2005 to -14.2 percent in 2009. The average five-year rate of return was 1.94 percent, whereas the average assumed rate was 7.93 percent.

State Pensions

Summary of Contributions to the Employees' Retirement System of Rhode Island
FY 1993 - FY 2011 State Employees and Teachers Only

	State Employees			Teachers (State Share)			Teachers (Local Share)		
Fiscal Year	Required Contribution $ million	Change	Percent Contributed	Required Contribution $ million	Change	Percent Contributed	Required Contribution $ million	Change	Percent Contributed
1993	$41.3	-2.1%	100.0%	$25.3	8.3%	100.0%	$43.2	-12.8%	100.0%
1994	47.6	15.3%	100.0%	32.7	29.6%	100.0%	47.1	9.1%	100.0%
1995	52.6	10.5%	66.0%	36.9	12.8%	81.0%	50.2	6.6%	100.0%
1996	42.9	-18.3%	100.0%	30.8	-16.6%	100.0%	47.2	-5.9%	100.0%
1997	45.4	5.7%	100.0%	34.9	13.3%	100.0%	48.9	3.6%	100.0%
1998	51.3	13.0%	100.0%	35.0	0.4%	100.0%	52.0	6.3%	100.0%
1999	48.5	-5.4%	100.0%	30.2	-13.7%	100.0%	42.4	-18.6%	100.0%
2000	44.4	-8.6%	100.0%	40.7	34.8%	100.0%	57.7	36.1%	100.0%
2001	44.5	0.4%	100.0%	35.4	-13.1%	100.0%	48.2	-16.5%	100.0%
2002	31.8	-28.6%	100.0%	30.8	-13.0%	100.0%	44.4	-7.8%	100.0%
2003	45.1	41.9%	100.0%	38.2	24.3%	100.0%	55.5	25.0%	100.0%
2004	55.7	23.4%	100.0%	45.0	17.8%	100.0%	70.7	27.3%	100.0%
2005	66.1	18.7%	100.0%	48.8	8.4%	100.0%	73.0	3.3%	100.0%
2006	91.3	38.1%	100.0%	54.5	11.7%	100.0%	83.8	14.8%	100.0%
2007	118.3	29.6%	100.0%	72.0	31.9%	100.0%	107.9	28.8%	100.0%
2008	131.6	11.2%	100.0%	82.2	14.2%	100.0%	123.2	14.2%	100.0%
2009	127.1	-3.4%	100.0%	79.2	-3.7%	100.0%	118.7	-3.7%	100.0%
2010*	127.8	0.6%	ND	81.8	3.3%	ND	122.7	3.3%	ND
2011	133.2	4.2%	ND	84.8	3.7%	ND	127.3	3.7%	ND

Note: Does not include any savings associated with pension changes as submitted in the FY 2010 S and FY 2011 budgets.

Source: Testimony - March 12, 2008 to Special House Commission to Study All Aspects of The State Pension Retirement System, Frank Karpinski, Executive Director, Employees' Retirement System of Rhode Island; Actuarial Valuation Report as of June, 2008

* State Employees Original Estimated Employer payment $148.4 FY 2010; Teacher Original Estimated Employer payment $249.0 FY 2010

FY 2001-FY 2011 State Contributions

- Between FY 2001 and FY 2011, the State's ARC for ERS plans (State general employees and teachers) has increased from $79.9 million in all funds to $218.0 million, an increase of 172.9 percent.
- The local annual required pension contribution for teachers increased 164.3 percent during the same time period, growing from $48.2 million in FY 2001 to $127.3 million in FY 2011.
- In FY 2001, the employer contribution rate for State employees and teachers was 7.99 percent and 12.01 percent, respectively; by FY 2011, the rates had increased to 21.64 percent for State employees and 20.07 percent for teachers. The teacher employer rate is shared by State government (40 percent) and local government (60 percent). Employee contribution rates remained at 8.75 percent for State employees and 9.5 percent for teachers.
- Since 1996, Rhode Island has consistently met its actuarially required contributions.

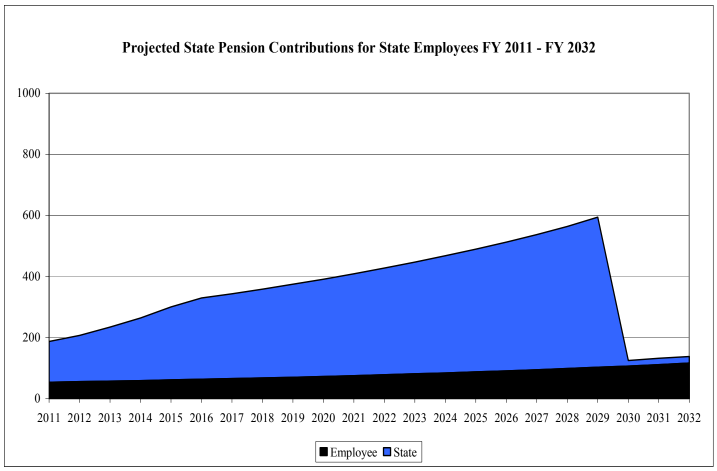
Projected State Contributions (General Revenue Expenditures)

Employees' Retirement System of Rhode Island
State Contributions (General Revenue Expenditures, $ million)

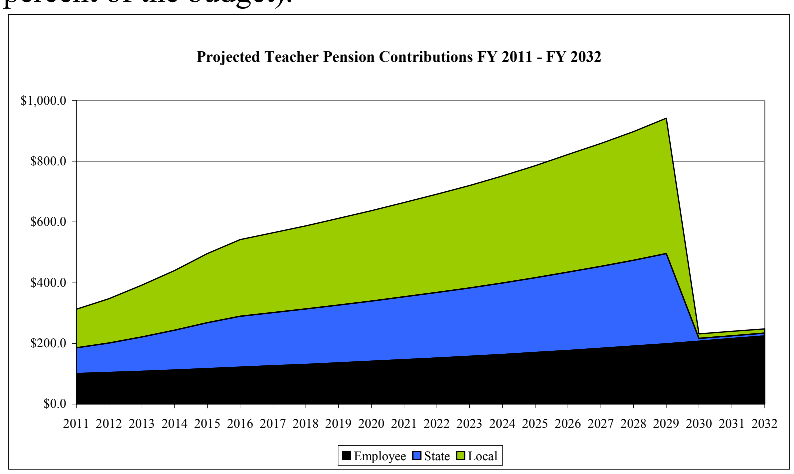
	FY 2010S			FY 2011P			FY 2015		
	Current Law	Pension Changes	Savings	Current Law	Pension Changes	Savings	Current Law	Pension Changes	Savings
State Contribution									
State Employees	$75.6	$64.3	($11.3)	$77.9	$67.3	($10.6)	$139.2	$128.6	($10.6)
Teachers-State Share	76.3	64.0	(12.3)	79.7	66.8	(12.9)	146.7	133.8	(12.9)
Total State	**$151.9**	**$128.3**	**($23.6)**	**$157.6**	**$134.1**	**($23.5)**	**$285.9**	**$262.4**	**($23.5)**
As Percent of Budget	5.1%	4.5%	-10.9%	5.5%	4.7%	-14.2%	7.8%	7.2%	-7.6%

Note: Numbers may vary slightly from data as reported by the Actuary. Data for State employees do not include State police or judges.
Source: FY 2010S and FY 2011P as submitted, State Budget Office, House Fiscal Staff, Senate Fiscal Staff, RIPEC calculations.

- Between FY 2011 and FY 2015, the State's estimated employer contribution (general revenue expenditures) for State employees and teachers is projected to increase from $157.6 million in FY 2011 to $285.9 million in FY 2015, assuming no changes were made to the pension system. In FY 2011, the contribution would account for 5.5 percent of the State's general revenue expenditures, increasing to 7.8 percent by FY 2015.



- Assuming that the proposed pension changes were implemented, the State's estimated employer contribution for State employees and teachers would increase from $134.1 million in general revenue expenditures (4.7 percent of the budget) to $262.4 million in FY 2015 (7.2 percent of the budget).



Municipal Pensions

Rhode Island municipal governments provide pension benefits to their employees either through the State-run Municipal Employees Retirement System (MERS) or through locally-administered plans. Currently, the State of Rhode Island administers the Municipal Employees Retirement System (MERS) for approximately 110 municipal pension plans for general employees, police and fire, for about 30 municipal governments. Thirty-six pension plans are locally-administered by 24 communities.

<u>Comparison MERS to Locally-Administered Pension Plans</u>

Rhode Island's Local Government Pensions
Summary Data ($ million)

	MERS*	Locally-Admin. Plans**
Assets	$1,174.6	$1,419.7
Liabilities	$1,266.3	$3,314.3
Unfunded Liability	$91.7	$1,894.6
Aggregate Funding Ratio	92.8%	42.8%

*Municipal Employees' Retirement System (MERS), Actuarial Valuation Report as of June 30, 2008

** Based on Auditor General's report "Status of Pension and OPEB Plans Administered by RI Municipalities", March 2010

- The estimated funding ratio for MERS is 92.8 percent as of June 30, 2008, the most recent actuarial valuation date. The locally-administered pension plans had an estimated collective funding ratio of 42.8 percent (as of the most recent information included in the FY 2009 audits). One should note that there is a wide range of funding ratios among the locally-administered plans, ranging from 0.0 percent for the pre-1974 Policemen and Firemen pay-as-you-go plan in Pawtucket (71 retirees) to 104.9 percent for Warwick's Police Pension II Plan.
- MERS has an unfunded liability of $91.7 million (as of June 30, 2008) and locally-administered plans an unfunded liability of $1.9 billion (as of the most recent audit reports).
- Annually required contributions for MERS plans amounted to $33.4 million in FY 2009. Plans covered in MERS are required to make 100 percent of their ARC payments. For locally-administered plans, the average payments were 82 percent of the ARC in FY 2009. This is the lowest percentage in the last five years; in 2005 it was 85 percent, 87 percent in 2006 and 2007, and 86 percent in 2008. ARC payments in 2009 varied widely among the communities (see Appendix for a detailed overview by community).
- The Rhode Island Auditor General noted that, at the time of the report, 23 of the 36 locally-administered pension plans were considered at risk. These plans were administered in 18 communities. Seven of these plans were severely underfunded (less than 60 percent) and annual contributions were significantly less than annual required amounts (less than 80

percent). Twelve plans were significantly underfunded and annual contributions were more than 80 percent of annual required amounts, and four plans were more than 60 percent funded, but annual contributions were significantly less than required amounts (less than 80 percent and generally declining over a multi-year period).

Investment Rate of Return History
Actual Rate of Return

Year Ending June 30,	ERS/MERS	Locally-Ad. Average
2005	11.4%	6.3%
2006	11.6%	7.5%
2007	18.2%	14.0%
2008	-5.8%	-3.8%
2009	-19.2%	-14.2%
Average Returns and Average Assumed Rates		
Last 5 years	3.20%	1.94%
Assumed Rate	8.25%	7.93%
Difference	-5.05%	-5.99%

SOURCE: ERSRI; Actuarial Valuation Report for Fiscal Year Ending June 30, 2008
Auditor General's report "Status of Pension and OPEB Plans Administered by RI Municipalities", March 2010.

- After annual required contributions, the next most important factor impacting the financial health of a pension plan is overall investment performance. Achieving average investment returns equal to the assumed rate of return is necessary to meet planned funding targets. Failure to meet the assumed rate of return adds to the growth in plan liabilities.
- The assumed rates of return for pension plans administered by Rhode Island municipalities range from 7.0 percent to 8.5 percent. The assumed rate of return used by the State of Rhode Island Employees Retirement System is 8.25 percent.
- According to the Auditor General's report, the average five-year investment performance of the locally-administered pension plans was, in most instances, less than the returns earned by the ERS. The collective average return was 1.94 percent compared to 3.20 percent earned by ERS. One should note that some municipalities were excluded from the Auditor General's average calculation due to inconsistent measurement periods.

Other Post Employment Benefits

Other Post Employment Benefits (OPEB) include post employment healthcare, as well as other forms of post employment benefits (for example, life insurance) when provided separately from a pension plan.

- The Government Accounting Standards Board (GASB) does not require advanced funding of OPEB liabilities. The impact of the decision to fund or not, however, will have a significant impact on the accounting process. The standard creates strong incentives to fund. Employers who fund these benefits will generally be able to use more favorable accounting methods, which result in significantly lower OPEB costs. GASB allows a funded plan to use a higher discount rate (assumed investment return) than an unfunded plan. A funded plan may use a discount rate in the 7-8 percent range while an unfunded plan is restricted to using a rate in the 4-5 percent range.
- Furthermore, all employers will need to understand the impact of any unfunded liability on their bond ratings since bond rating agencies may look unfavorably on governmental employers that do not have a plan for funding their OPEB obligations.
- In addition, the State's and municipal bond ratings may be affected by the results of GASB valuations and related decisions on whether to fund the liabilities. The cost of borrowing may increase and bond ratings may be affected if liabilities are unfunded or strategies are not developed to manage costs.

State OPEB Liability

State OPEB Liability ($ million)
FY 2009

	ARC	Payment	UAAL	Funding Ratio
State Employees	$34.7	$33.4	$679.5	0.0%
Teachers*	1.4	2.2	10.2	0.0%
Judges	1.1	0.2	14.1	0.0%
State Police	4.6	2.0	54.6	0.0%
Legislators	0.3	0.1	29.7	0.0%
Total State	**$42.1**	**$37.9**	**$788.1**	**0.0%**

*Local Teachers Buy in

Source: GRS OPEB Valuation as of June 30, 2005 (ARC payment) and as of June 30, 2007 (UAAL)

- The State's ARC payments for State employees, teachers, judges, State police and legislators combined was $42.1 million for FY 2009, whereas actual payments were $37.9 million. The total OPEB liability was $788.1 million.
- The Governor recommends in his FY 2011 proposed budget to fund retiree health benefits based on an actuarial method rather than the current "pay-as-you-go" method. The FY 2011 rate reflects the actuarial basis for current benefits to retirees as well as covering costs associated with the 30-year amortization of the unfunded actuarial accrued liability (UAAL). It is proposed to place the latter amount in a separately administered trust fund.

Local Government OPEB Liability

For the first time, local governments are required to report the liability created by OPEB afforded current employees and retirees.

Municipal OPEB ARC Payments and Contributions	
ARC	$189,585,215
Contribution	$100,838,155
ARC Payments	
As Percent of Budget	5.9%
As Percent of Tax Levy	9.6%
Contributions	
As Percent of Budget	3.2%
As Percent of Tax Levy	5.1%

Source: Auditor General's report "Status of Pension and OPEB Plans Administered by RI Municipalities", March 2010; Division of Municipal Finance; RIPEC calculations

- The table above shows the annual cost to fund OPEB expenses and the payments actually made during FY 2009, based on data from the Auditor General. Municipal expenditure data for municipalities are for the FY 2009 budget, based on data from the Division of Municipal Finance.
- Annual required contributions were $189.6 million at June 30, 2009. Total ARC payments would have absorbed 5.9 percent of municipal budgets, or amounted to 9.6 percent of the tax levy, if municipalities had paid them in full.
- The actual contributions made by municipalities were $100.8 million, amounting to 3.2 percent of municipal budgets, or 5.1 percent of the tax levy.
- The estimated unfunded liability for municipal retiree health care benefits (including education) is almost $2.4 billion. This amount is 75.1 percent of the annual total combined budgets for local government in FY 2009.
- As of the year ending June 30, 2009, collectively, 30 communities and four regional school districts have reserved less than 1.0 percent of the required funding to fully fund the current liability (nine communities were not required to, or did not, report).
- The eight urban core and urban ring communities, where information was available, account for 72.5 percent of that liability ($1,733.6 million). No data were included for East Providence and Woonsocket.
- Of the 30 communities reporting, eight (Barrington, Bristol, Cranston, Newport, Smithfield South Kingston, Warren and Westerly) have established trust funds to begin funding their OPEB liability.
- One should note that several communities did not have to comply with the requirement of preparing an actuarial study or did not provide the Auditor General their actuarial study as part of the FY 2009 audit. Also, East Providence is on a different fiscal year and will respond later. Furthermore, not all of the communities have current actuarial reports as of the end of fiscal year 2009. The data presented in this report are the most recent available; however, they are for different fiscal years.
- Data for individual communities are provided in the Appendix.

Municipal Pension Contributions and Unfunded Liabilities (including MERS and locally-administered plans)

Municipal Government Pension and OPEB Liability

Unfunded Pension Liability			
MERS	$91,719,624		
Locally-administered Plans	1,894,606,900		
Total Unfunded Liability	$1,986,326,524		
OPEB Unfunded Liability	$2,392,688,011		
Total Liability (Pension and OPEB)	**$4,379,014,535**		
	Pension	**OPEB**	**Total**
Total Unfunded Liability			
As Percent of Total Budget	62.3%	75.1%	137.4%
As Percent of Total Levy	101.0%	121.7%	222.8%

Source: Auditor General's report "Status of Pension and OPEB Plans Administered by RI Municipalities", March 2010; Division of Municipal Finance; RIPEC calculations

- As of June 30, 2008, the unfunded liability for the local pension plans covered in MERS amounted to $91.7 million. The unfunded liability was $2.0 billion for locally-administered plans, as reported in the Auditor General's report in March 2010.
- The total unfunded liability for municipal pensions amounts to 62.3 percent of municipal budgets (including education) and was higher than the total levy for FY 2009.
- If the unfunded liability for OPEB Post Employment Benefits is added, the total municipal unfunded liability amounts to $4.4 billion.

Overview of Proposed Pension System and Retiree Health Care Changes

The Governor's FY 2010 Supplement Budget included three articles, which, if passed, would have an impact on local pensions. Article 13 applies to municipal plans – both those administered by MERS and locally-administered plans, while Article 16 includes provisions which affect the local contribution to teacher retirement. The Articles are summarized below.

Relating to Municipal Retirement (Article 13)
This article provides for a variety of changes to municipal pension plans administered by either the State (MERS) or by municipalities. The changes include reduction to disability pensions, consistent with changes made at the State level last year, changes to years of service requirements and minimum retirement ages for regular and public safety employees, increases employee contributions, elimination of COLA for employees not eligible to retire before July 1, 2010, and mandatory cost-sharing for retiree health insurance for current and future retirees.

In addition, it prohibits locally administered plans from offering more generous benefits than available through the State administered municipal plans by requiring that age, years of service, and contribution rates established in MERS apply to all locally-administered plans.

Although no fiscal impact was attached to the article, actuarial estimates established in the spring of 2009 concluded that these changes would create $14.2 million in savings across all communities that participated in MERS. No estimates were provided for non-MERS participants.

Relating to Pension Reform (Article 16)

As part of the FY 2010 Supplemental Budget, the Governor has submitted Article 16, which includes a number of further modifications to the pension system. This article eliminates the Cost-of-Living-Adjustment (COLA) for State employees, teachers, judges, and State Police who retire after September 30, 2009, with the exception of those employees who were eligible to retire prior to September 30, 2009. Furthermore, it does not prevent the General Assembly from annually reviewing and providing an ad hoc COLA to retired State employees, not otherwise eligible, up to the maximum amount of 3.0 percent or the CPI.

The article also provides that no supplemental contributions be made to the Retirement System for FY 2009, 2010 and FY 2011. Rhode Island General Law requires that for any fiscal year in which the actuarially determined State contribution rate for State employees or teachers is lower than that for the prior fiscal year, the Governor shall include an appropriation to that system equal to 20.0 percent of the rate reduction for the State's contribution rate to be applied to the actuarial accrued liability of the system.

Based on Budget Office estimates, this article would generate $41.7 million in savings, $18.5 million of which is by reducing education aid by the estimated local share of savings (in effect, if passed, the article would be net-neutral to municipalities). The General Assembly has not acted as of yet on any changes to the municipal pension changes proposed in the Governor's FY 2010 Supplemental Budget.

Relating to School Employee Health Insurance, Article 23

This article removes health care benefits from the teachers and school employees' collective bargaining process and requires that these employees, upon expiration of their current contracts, receive coverage under a new uniform public school employee health care benefits program. This article authorizes the Department of Administration to create uniform health care benefits for all Rhode Island school districts and charter school employees including, but not limited to, medical benefits and prescription drug coverage. The choice of benefit plans from those approved in accordance with the new plan, medical insurance cost-sharing, payment for waiving medical insurance, and providing benefits for retirees shall continue to be negotiated through the collective bargaining process. The value of any approved plan may not be greater than the value of the State employee health plan.

There are no savings assumed in the budget from the passage of this article. Information gathered by RIDE during FY 2007 indicates that districts would be able to achieve annual savings of approximately $17.1 million through competitive bidding, establishment of a limited number of common plan designs resulting in reduced administrative fees, and co-sharing and buy-back provisions. Some districts have implemented such provisions since then, which will lower the overall savings.

Definition and Overview of Terms

A **Pension Plan** is a program to provide a benefit to employees who meet minimum requirements based on age and years of service to receive a portion of their salary post-employment. A pension plan represents a liability – an obligation to pay future benefits to employees. Pension plans acquire assets through contributions from employees and employers, as well as earnings on the assets invested. Assets grow when investments increase at a faster rate than assumed, benefits decline, or a combination of both. An unfunded liability occurs when liabilities exceed the assets available.

There are essentially two types of pension plans, which are very different from each other in terms of who bears the risk, how a benefit is calculated, how the funds are invested, and how they influence behavior.

A **Defined Benefit Plan** is a plan that promises a benefit to employees based on eligibility, years of service (often, under these types of plans, credit is given for outside service, such as that in the military), retirement age, and a salary base. This benefit is paid regardless of the performance of the assets in the pension fund. These plans are typically pre-funded by contributions from both employees and the employer. The plans typically have disability components, COLA provisions, and Social Security offset provisions. A defined benefit plan is generally considered a low risk to the employee in that the employer bears the risk and reward of the fund performance and actuarial performance, while the employees generally bear inflation risk and potential job loss before eligibility.

*A **defined benefit** pension plan promises a benefit to employees who meet a series of criteria.*

*A **defined contribution** plan promises a contribution to a retirement savings fund by the employer.*

*A **hybrid** plan attempts to take elements of both plans to spread the risk among employers and employees.*

Because defined benefit plans provide guaranteed lifetime income to retirees, they provide more income for career employees, which, in turn, increase the likelihood of longer service. However, this also means that, should an employee leave service prematurely, that employee stands to lose a significant investment. Therefore, defined benefit plans tend to encourage longer terms of service, reduce mobility, and can create a more expensive climate and workforce due to longer employment, which results in higher salaries and lower turnover.

Generally speaking, public employee defined benefit programs tend to have higher benefit levels than those in the private sector. In the public sector, employees participating in Social Security have a median accrual rate of 1.9 percent while those not participating in Social Security have an estimated rate of 2.2 percent, and private sector defined benefit employees have a 1.5 percent rate. These percentages are typically applied to each year of service and the final average salary. One should note that all private sector employees must participate in Social Security while public sector employee participation is not mandatory.

A **Defined Contribution Plan** is a plan that promises a contribution to a retirement savings fund by the employer. Typically, the employer contributes a percentage of salary, often with a minimum contribution by the employee for the employer match. Most plans require workers to affirmatively elect to enroll in a defined contribution plan although an increasing number of plans automatically enroll employees (designed to increase participation). Private sector plans are almost entirely 401(k) plans.

The benefit amount is determined primarily by contribution rates and the rate of return on accumulated assets invested. Again, these plans are typically funded by contributions from both the employee and the employer. However, the employee bears the risk (and reward) based on the asset performance in the funds. Whatever is in the fund is what is available for retirement. A distinct advantage of this type of plan is that it is portable. It can also be drawn down in installments or in one lump sum.

There are essentially four types of defined contribution plans:

401(k) Plans permit primarily private sector employees to defer a portion of their pay to a qualified tax-deferred plan. Employers often make contributions to these plans, but the employee typically directs the investments of the funds.

401(a) Money purchase plans, with employee and employer contributions structured as mandatory or voluntary - the employer decides on the method of participant contribution, as well as whether participant contributions will be made on a pre-tax (picked-up contributions) or an after-tax basis. These types of plans are available to governmental units.

403(b) Plans permit public education employees to defer a portion of their pay to a qualified tax deferred plan. These funds are invested in annuity contracts through insurance companies or through mutual funds. Employers often make contributions to the plans.

457(b) Plans permit employees to defer their pay. Employees are immediately vested in the funds, which will not be taxed until the funds are paid from the plan.

A **Hybrid Plan** is designed to distribute the share of risk and reward between employer and employee by combining components of a defined benefit with a defined contribution plan. The Federal Employees Retirement System is one example of a hybrid plan.

Annual required contributions (ARC) – Actuaries annually calculate a contribution amount that would maintain or improve the funding status of a pension plan, ensuring that the amounts set aside in reserve would not only cover current benefits but a portion of estimated unfunded liabilities. A government's ability to maintain its ARC is critical and determines whether or not the entity is keeping pace with benefits accumulated. Should a government contribute less than actuarially required, the assets in the pension fund would eventually be insufficient to meet obligations, and this cost would fall on future generations of taxpayers. The most common reason for a government to underfund its contribution is financial crisis. However, to minimize significant fluctuations in the ARC, state and local governments often use smoothing techniques, which use the average of the plan's assets over a number of years to determine the contribution rates.

Funded ratio - represents the percentage of plan liabilities covered by the plan assets. Low ratios will eventually require additional funding, either from government or employee contributions.

Unfunded Actuarial Accrued Liability (UAAL) – The dollar amount of benefits accrued for which no funds are set aside to cover. An unfunded liability indicates the degree of accumulated liabilities over assets. Unfunded liabilities can occur when state and local governments fail to make the full contribution to the fund, actual returns on investments of the assets are lower than assumed, or there is an increase in benefits. Demographic factors, such as age of retirement and longevity can increase the liability as well. Faltering pension assets due to low contributions, poor investment returns, and inaccurate demographic factors can translate into greater fiscal and budgetary problems for the future.

Cost of living provisions (COLA) – for pension benefits are designed to ensure that the benefit does not erode over time due to inflation costs. These provisions vary among the states, and differ if states have multiple tiers or schedules for their pension systems.

APPENDIX

The following tables are from the Auditor General's report "Status of Pension and OPEB Plans Administered by Rhode Island Municipalities", March 2010.

Rhode Island Municipalities' Other Post-Employment Benefit (OPEB) Plans at June 30, 2009

Municipality	Type of Plan	ARC	Contributions	% of ARC	Net OPEB Obligation (Asset)	Date of Valuation	Actuarial Value of Assets	Actuarial Accrued Liability	Unfunded Actuarial Accrued Liablity	Funded Ratio
Barrington	Trust Fund	$ 2,597,104	$ 2,147,711	**82.70%**	449,393	6/30/2009	$ 3,513,802	$ 21,471,689	$ 17,957,887	16.4%
Bristol	Trust Fund	844,000	889,043	**105.34%**	(377,778)	7/1/2008	1,675,000	12,862,000	11,187,000	13.0%
Burrillville	Pay-as-you-go	129,436	106,868	**82.56%**	22,568	7/1/2008	$ -	$ 1,675,408	1,675,408	0.0%
Central Falls	Pay-as-you-go	1,963,061	1,394,009	**71.01%**	569,052	7/1/2008	-	30,693,955	30,693,955	0.0%
Charlestown (21)	Trust Fund	385,000	636,782	**165.40%**	(251,782)	7/1/2006	-	3,391,000	3,391,000	0.0%
Coventry	Pay-as-you-go	1,200,000	872,000	**72.67%**	328,000	7/1/2009	-	12,835,000	12,835,000	0.0%
Cranston - *Public Safety*	Trust Fund	4,047,835	3,273,843	**80.88%**	500,677	7/1/2009	397,327	50,533,441	50,136,114	0.8%
- Board of Education	Pay-as-you-go	3,504,375	2,288,090	**65.29%**	1,642,251	7/1/2008	-	35,821,039	35,821,039	0.0%
Cumberland	Pay-as-you-go	3,743,000	1,569,191	**41.92%**	2,173,809	7/1/2008	-	46,872,000	46,872,000	0.0%
East Greenwich	Pay-as-you-go	1,262,545	276,218	**21.88%**	986,327	7/1/2008	-	10,504,613	10,504,613	0.0%
Glocester	Pay-as-you-go	192,932	152,619	**79.11%**	105,315	7/1/2008	-	2,199,146	2,199,146	0.0%
Jamestown - *Police Plan*	Pay-as-you-go	233,368	90,500	**38.78%**	104,126	1/12008	-	1,874,075	1,874,075	0.0%
- School Plan	Pay-as-you-go	905,779	348,153	**38.44%**	420,382	7/1/2007	-	13,129,596	13,129,596	0.0%
Johnston	Pay-as-you-go	18,202,814	4,397,410	**24.16%**	13,805,404	6/30/2008	-	226,245,500	226,245,500	0.0%
Lincoln	Pay-as-you-go	1,907,362	907,686	**47.59%**	999,676	6/30/2009	-	23,939,601	23,939,601	0.0%
Middletown (22)	Pay-as-you-go	1,535,690	491,806	**32.03%**	n/a	7/1/2007	-	21,552,897	21,552,897	0.0%
Narragansett	Pay-as-you-go	6,406,441	1,384,467	**21.61%**	5,021,974	7/1/2008	-	70,365,417	70,365,417	0.0%
Newport	Trust Fund	10,238,391	11,099,555	**108.41%**	9,037,637	7/1/2008	4,464,395	142,838,552	138,374,157	3.1%
North Kingstown	Pay-as-you-go	2,290,415	941,768	**41.12%**	1,348,647	7/1/2007	-	25,294,765	25,294,765	0.0%
North Providence	Pay-as-you-go	4,039,000	1,646,000	**40.75%**	2,426,000	7/1/2008	-	52,758,000	52,758,000	0.0%
North Smithfield	Pay-as-you-go	538,195	323,283	**60.07%**	478,262	7/1/2007	-	5,793,469	5,793,469	0.0%
Pawtucket	Pay-as-you-go	31,011,620	10,032,096	**32.35%**	40,390,667	7/1/20008	-	437,601,577	437,601,577	0.0%
Portsmouth - *Town Plan*	Pay-as-you-go	1,569,039	462,590	**29.48%**	1,106,449	7/1/20008	-	13,026,759	13,026,759	0.0%
- School Plan	Pay-as-you-go	511,670	299,602	**58.55%**	212,068	7/1/2007	-	4,514,458	4,514,458	0.0%
Providence	Pay-as-you-go	43,147,000	35,022,000	**81.17%**	13,047,000	7/1/2008		593,903,000	593,903,000	0.0%
Scituate	Pay-as-you-go	529,719	138,475	**26.14%**	391,244	3/31/2009	-	4,713,768	4,713,768	0.0%
Smithfield	Pay-as-you-go	2,324,739	1,455,607	**62.61%**	869,132	7/1/2009		26,277,276	26,277,276	0.0%
South Kingstown (See Note 3)	Trust Fund	1,694,400	1,426,200	**84.17%**	268,200	7/1/2007	-	15,988,000	15,988,000	0.0%
Tiverton	Pay-as-you-go	3,175,366	1,255,056	**39.52%**	1,920,310	7/1/2008	-	34,838,000	34,838,000	0.0%
Warren (See Note 4)	Trust Fund	383,807	-	**0.00%**	508,894	7/1/2007	700,000	3,018,423	2,318,423	23.2%
Warwick - *City Plan*	Pay-as-you-go	18,856,800	6,705,018	**35.56%**	23,622,803	7/1/2009	-	210,272,745	210,272,745	0.0%
- School Plan	Pay-as-you-go	5,553,088	1,692,036	**30.47%**	7,801,248	7/1/2009	-	47,479,237	47,479,237	0.0%
West Warwick	Pay-as-you-go	8,868,698	3,096,416	**34.91%**	5,772,282	7/1/2008	-	136,587,286	136,587,286	0.0%
Westerly - Police Plan	Trust Fund	433,200	366,250	**84.55%**	66,950	7/1/2008	7,301,108	11,319,636	4,018,528	64.5%
- School Plan	Pay-as-you-go	532,439	419,054	**78.70%**	113,385	7/1/2008	-	1,576,533	1,576,533	0.0%
Regional School Districts										
Bristol-Warren	Pay-as-you-go	3,780,721	2,410,915	**63.77%**	2,744,751	7/1/2007	-	47,863,133	47,863,133	0.0%
Chariho	Pay-as-you-go	245,900	188,393	**76.61%**	130,862	7/1/2008	-	2,018,516	2,018,516	0.0%
Exeter-West Greenwich	Pay-as-you-go	397,094	255,401	**64.32%**	141,693	7/1/2008	-	3,554,702	3,554,702	0.0%
Foster-Glocester	Pay-as-you-go	403,172	376,044	**93.27%**	27,128	7/1/2009	-	3,535,431	3,535,431	0.0%
	Totals:	**$ 189,585,215**	**$ 100,838,155**	**53.19%**	**$ 138,925,006**		**$ 18,051,632**	**$ 2,410,739,643**	**$ 2,392,688,011**	0.7%