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Public Policy Issue Brief

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Reforming Public Sector Pensions

Public sector employee benefits have been at the forefront of public consciousness as state and local governments continue to feel the effects of the "Great Recession". Market volatility, combined with changing assumptions regarding mortality and wages, have resulted in significant growth in unfunded liabilities and, thus, funding obligations on the part of state and local governments. This issue brief is intended to provide context to the discussion of pension reform as the Governor, General Treasurer and General Assembly work to craft pension legislation that is equitable to taxpayers and employees alike.

Introduction

The combined impact of an aging public sector workforce, investment losses and changing actuarial assumptions has created a pension crisis for state and local governments around the country. An April 2011 Pew Center report, *"The Widening Gap: The Great Recessions Impact on State Pension and Retiree Health Care Costs"* estimates that the unfunded liability for retiree benefits across the country was $1.3 trillion in 2009, $660 billion of which was related to pension shortfalls. In Rhode Island, the current unfunded liability for the Employees' Retirement System of Rhode Island (ERSRI), which covers state general employees and teachers, was estimated at $6.8 billion. The projected annual contribution for state and local governments in FY 2013 is estimated at $614.8 million, which is expected to grow to over $1.0 billion in FY 2022.

Table 1
Change in Estimated State Pension Liabilities
FY 2013 ($ million)*

	June 2010 ARC	Revised ARC	Change	June 2010 UAAL	Revised UAAL	Change
State						
State Employees	$182.5	$243.0	33.2%	$2,119.0	$2,700.0	27.4%
Teachers-State Share	113.1	148.7	31.5%	1,311.2	1,653.2	26.1%
Subtotal State	*$295.62*	*$391.72*	*32.5%*	*$3,430.2*	*$4,353.2*	*26.9%*
Local						
Teachers-Local Share	$169.7	$223.1	31.5%	$1,966.8	$2,479.8	26.1%
Total	**$465.3**	**$614.8**	***32.1%***	**$5,397.0**	**$6,833.0**	***26.6%***

ARC= Annually required contribution; UAAL = Unfunded actuarially accrued liability

* Estimated ARC payment and unfunded liability based on experience study results

SOURCE: "Actuarial Analysis of the Rhode Island Retirement Security Act of 2011, as described in S1111A and H6319A"; RIPEC calculations

Long-term sustainability of public sector retirement benefits has become an issue of increasing concern as pension costs continue to rise, in Rhode Island and nationally. As pension costs balloon, and the composition of the workforce changes, many governments have started to examine alternate benefit designs. The 2011 Pension Advisory Group in Rhode Island was established jointly by the Governor and General Treasurer. The group conducted a series of public meetings in which the Advisory Group provided input and organized information about pension reform organized around four goals:

- Attracting quality employees;
- Providing a level of security for retirees;
- Preserving funding for public services; and
- Protecting taxpayers.

Rhode Island's state general employee pension fund is among the worst-funded in the nation. Based on Pew Center data for FY 2009, the plan's funded level of 59 percent was the third-lowest in the country. Only West Virginia (56 percent) and Illinois (51 percent) had lower funding levels. Amortizing this unfunded liability – that is, paying off the unfunded liability under the current schedule – is expected to significantly increase the state's required pension payments in the coming years, limiting the state's ability to make strategic investments in other programs, or requiring tax increases, unless changes are made to the current system.

The following sections of this issue brief provide information on a number of pension-related issues including: a description of different types of retirement plans and trends in plan design; key pension funding and benefit concepts; pension reforms around the country and a history of pension reform in Rhode Island; and an overview of the proposed changes currently before the General Assembly.

Types of Retirement Plans

In the broadest of terms, a pension plan is a program to provide a benefit to individuals who no longer receive income from regular employment. Historically, there have been two types of pension systems – defined benefit (DB) and defined contribution (DC) – 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. However, hybrid plans, which blend elements of both DB and DC plans, have emerged as a third option, providing a range of investment risk, funding sources and payment options.

*A **defined benefit** plan promises a benefit to employees who meet a set series of criteria. A **defined contribution** plan promises a contribution to a retirement savings fund by an employer. A **hybrid** plan takes elements of both plans to spread the risk between employers and employees.*

Defined Benefit Plans

Defined benefit plans promise a specified benefit to employees based on a number of factors such as years of service, retirement age and salary, and are the most common type of plan in the public sector. These plans are typically pre-funded by contributions from both employees and the employer. In addition to a set monthly payment upon retirement, the plans typically have disability components, cost-of-living adjustment (COLA) provisions, and Social Security offset provisions. Benefits from DB plans are paid regardless of the performance of the assets invested in the pension fund. Because of this, DB plans are generally considered low risk for the employee in that the employer bears the risk and reward

for market performance and the accuracy of assumptions, such as mortality, built into the plan valuations.

At the same time, employees generally bear inflation risk post-retirement if benefits are not adjusted, as well as potential job loss before eligibility. Because defined benefit plans provide guaranteed lifetime income to retirees, they provide more income for career employees which, in turn, may increase the likelihood of longer service. However, this also means that, should an employee leave service prematurely, the 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, resulting in higher salaries and lower turnover.

Defined Contribution Plans

In a defined contribution (DC) plan, the employee and (usually) employer contribute to an individual retirement savings account. Typically, the employer contributes a percentage of salary, often with a minimum contribution by the employee for the employer match. These funds are typically invested at the direction of the employee, and returns on the investments are credited (or deducted) from the individual account. 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). While the majority of private sector plans are 401(k) plans, there are a number of different types of DC plans (see inset).

Examples 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 may contribute, but the employee typically directs the investments of the funds.* ***Money Purchase (401(a)) Plans*** *require fixed contributions from the employer to the employee's account and the employer determines the method of employee contribution and whether the contributions are pre- or post-tax; plans exist in both the public and private sectors.* ***403(b)*** *plans allow public education and employees of 501(c)3 organizations to defer a portion of their pay to a qualified tax-deferred plan to which an employer may also contribute.*

The benefit amount is determined primarily by contribution rates and the rate of return on accumulated assets invested. In contrast to DB plans, the employee bears the risk (and reward) based on the asset performance in the funds; whatever is in the account is the amount available for retirement. Additionally, unless, for example, an individual purchases an annuity upon retirement with their savings, the employee bears the risk of outliving their assets. Thus, benefits from DC plans into retirement depend on both the value of the account and how employees elect to take receipt of the funds.

A distinct advantage of DC plans over DB plans is that they are portable. That is, an employee may take their plan with them when they leave employment, may continue contributing to the plan, and the plan will continue to grow based on investment returns. While defined benefit plans are legally portable, portability is limited due to the fact that the actuarial value of the worker's vested accrued benefit is uncertain and DB plans are not transferable to a new employer. By contrast, the employer's liability for contributions in a DC plan ends with termination of employment and the value of benefits is known. Another potential benefit to DC plans is that they can, with some exceptions, be drawn down in installments or in one lump sum. In some cases, employers may offer the option to purchase annuity contracts or allow funds to be annuitized if the plan sponsor has a DB plan. This option helps guard against the risk that the employee may outlive their funds.

Hybrid Plans

Hybrid plans have emerged as a means to distribute the share of risk and reward between employer and employee by combining components of a defined benefit with a defined contribution plan. Hybrid plans have increased in popularity over the years as demographics, such as an increasingly mobile workforce, and fiscal realities have presented challenges to traditional pension plans. At the same time, hybrid plans allow for an offset to challenges presented by systems in which the employee bears all the risk. The primary types of hybrid plans are:

- *Cash Balance Plans (CEP)* – a DB plan that is based on individual employee accounts as in a DC plan. In a CBP, the employer sets aside a percentage of the employee's salary and the balance earns interest at a set rate or a multiple of an indicator such as the yield on a Treasury bill, regardless of the plan's actual earnings. The plans may maintain the credit over the worker's career or may have a graded schedule based on age and duration of service. Payouts are required to have an annuity distribution but participants may elect to take a lump sum payout.
- *Pension Equity Plans (PEP)* – a DB plan that allows participants to accrue credits over their working life. Benefits are determined by multiplying the employee's final average salary by the sum of their accrued credits. Credits may be level over a career, or may vary with age and service. As with CBP, payouts may be made as an annuity or as a lump sum.

A third option for hybrid pension plan design is a combination DB/DC plan as in the federal government system (FERS). These plans typically couple a moderate DB share and a DC plan with an employer match that is usually capped at a percentage of salary. Participation in both plans is mandatory; employees are not permitted to choose between the two elements. Although these plans are not considered true hybrids, which must be DB plans under Treasury and IRS regulations, they have become increasingly popular throughout the country and are generally what state and local government officials mean when they refer to hybrid plans.

Table 2
Overview of Benefits, Risks and Responsibility by Plan

	DB	DC	DB/DC Hybrid	Cash Balance
Funding Source	Employer/ employee	Employee (with possible employer contribution)	Employer/ employee	Employer/ employee
Portable to New Employer?	No	Yes	Some	Yes
Investment Risk Responsibility	Employer	Employee	Employer and employee	Employer (until separation)
Rate of Return for Employee During Service	Guaranteed for employee contributions	Variable	Mixed	Guaranteed for employee contributions
Benefit Accrual	Back-loaded	Front-loaded	Part even, part back-loaded	Even (generally)
Potential to Outlive Funds?	No	Yes, unless annuity is purchased	No, if service requirement is met	No, if annuity is selected

SOURCE: "What are Hybrid Retirement Plans: A Quick Reference Guide", Center for State and Local Government Excellence, January 2011

Plan Comparison

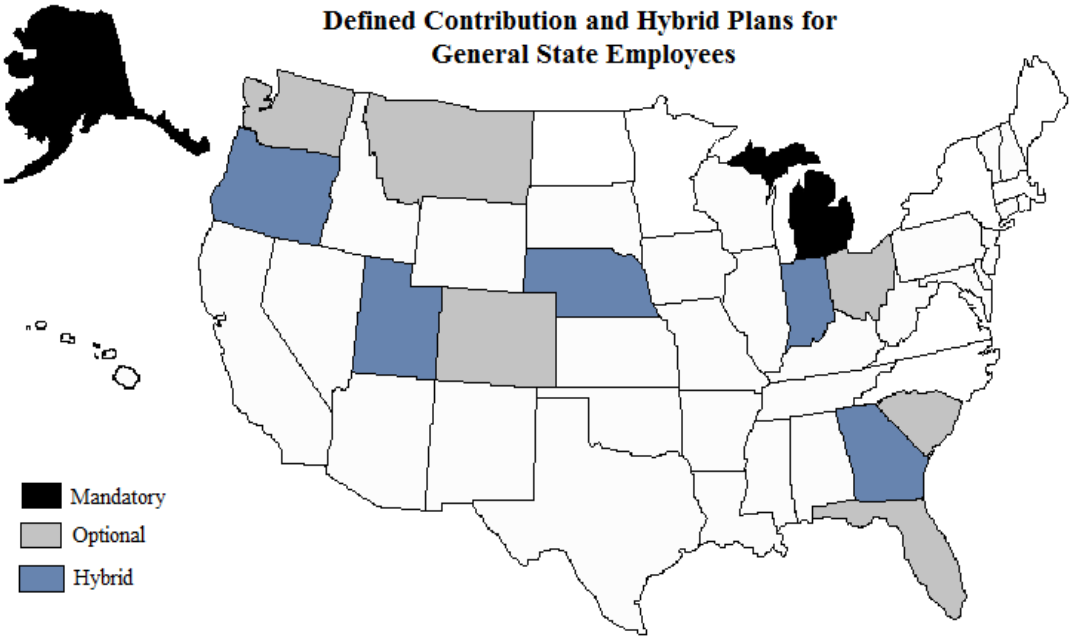
Table 2 outlines the benefits, risks and responsibility by plan design for DB, DC, DB/DC hybrids and cash balance plans. The advantages and disadvantages of each plan vary. For example, younger workers, who are more likely to hold a number of jobs throughout their working life, may be more attracted to DC plans because of the front-loaded nature of the plan, as well as the portability aspect. At the same time, DB plans offer stability through the guaranteed rate of return for employees and the fact that an employee cannot outlive their benefit. Governments must account for these various advantages and disadvantages, as changes to plan design may affect their ability attract and retain a quality workforce.

Trends in Plan Design

Currently, thirteen states have a DC plan or hybrid plan for general state employees, while 37 states have a mandatory DB plan. Most states use these plans to supplement other retirement programs, but both Michigan and Alaska have required all new hires (as of 2005 and 1997, respectively) to join their defined contribution program. Nebraska was the first state in the country to introduce a defined contribution plan for public employees in 1967, which was closed in 2002 and replaced with a cash balance plan.

Six of the thirteen states allow for new employees to choose between a DB and a DC plan, but employees must be a member of one or the other. Georgia, Indiana, Ohio, Oregon, Nebraska, Utah, and Washington have either a mandatory or optional hybrid plan. Outside of Nebraska, which, as noted above, has a cash balance plan, all states with hybrid plans have both DB and DC plan options. Florida had an optional hybrid plan, which is now closed.

Figure 1



* Nebraska has a cash balance plan; ** North Dakota has an optional DC plan for non-classified state employees, tha majority of whom are higher education employees. SOURCE: Snell, R. "State Defined Contribution and Hybrid Pension Plans", June 2010. National Conference of State Legislatures.

In addition, Indiana, Michigan, Utah and Washington have implemented hybrid plans for teachers, while Florida, South Carolina, and Ohio have optional DC plans for teachers. Alaska is the only state to have a mandatory DC plan in place for teachers.

Plan Funding – Key Concepts

This section summarizes key concepts related to the funding of defined benefit pension plans, including, where applicable, information on the current system for state general employees and teachers. All DB plans are funded through three sources: employer contributions, employee contributions and investment returns. The employer and employee contributions depend on a set of assumptions related to the current and future cost of benefits, although the risk for not meeting the assumptions varies between defined benefit and defined contribution plans.

Actuarial Assumptions

A set of assumptions made by the actuary that measure normal cost and the actuarial liability, based upon which the state's contribution is set. There are two types of assumptions: economic and demographic. Economic assumptions, which relate to current interest rates, assumed salary increases, inflation, and market performance. Demographic assumptions relate to characteristics and behavior of the participant group, such as retirement age and mortality. These assumptions are then used to calculate the expected future payment, discounted from the date of payment to current values (known as the present value of future benefits, or PVFB).

__Actuarial Assumptions__ are factors actuaries use to determine the cost of funding a defined benefit plan, such as investment return, mortality rates, and participant behavior. The __Normal Cost__ is the actuarial present value of benefits for service performed in the current year whereas the __Actuarial Accrued Liability (AAL)__ represents the present value of benefits for service earned (as of the valuation date). The difference between the __Actuarial Value of Assets__, that is, the value of pension plan investments and property used for the actuarial valuation, and the AAL is the __Unfunded Actuarial Accrued Liability (UAAL)__, while the ratio of a plan's assets to liabilities represents the __Funded Ratio__. Payments to reduce the UAAL over a set period of time are referred to as the __Amortization Cost__. Together, the normal cost and the amortization cost equal the __Annual Required Contribution (ARC)__.

If the actuary correctly predicts the above, contributions based on the normal cost are sufficient to fully fund the system; however, if assumptions are incorrect, which they often are due to normal market fluctuations and changing behavior, there is an actuarial loss that must be made up through additional contributions in future years. In Rhode Island, the Retirement Board is charged with enacting changes to the assumptions on which contributions are based. Based on the most recent Experience Study, the Board voted to make the following changes:

- Lowering the inflation assumption from 3 percent to 2.75 percent;
- Lowering the net real investment return assumption from 5.25 percent to 4.75 percent (lowering the nominal assumed investment return from 8.25 percent to 7.5 percent); and
- Increasing the life expectancy for all groups and adding a provision for continued future mortality improvement.

The impact of these changed assumptions increased the state's annual required contribution for state employees by 34.2 percent, from $295.6 million in FY 2010 to an estimated $396.6 million (assuming no changes) in FY 2013. The estimated annual payment for teachers, which is shared between the state

and local districts (split 40.0 percent and 60.0 percent, respectively) is projected to increase 32.7 percent, from $282.8 million in FY 2010 to $375.3 million in FY 2013. The total unfunded liability for the Employees' Retirement System of Rhode Island (ERSRI) increased from $5,397.0 million to $6.833.0 million, or by 26.6 percent.

Normal Cost

The actuarial present value of future benefits attributed to service in the current year, specifically, the current value of compensation deferred in the current year. The value is determined through actuarial assumptions, such as retirement age and value of future service, and a contribution rate is set that will meet the annual cost of providing those future benefits. However, the normal cost does not take into account risk related to market performance or whether actuarial assumptions are met. In a defined benefit (DB) system in which all assumptions are met, the normal cost is sufficient to fully fund the system; however, if actuarial assumptions or past funding obligations are not met, additional funding is necessary.

Table 3
Normal Cost Changes, FY 2013

	State		Teacher*	
	Before Changes	With Changes	Before Changes	With Changes
Employer	0.60%	2.64%	0.50%	2.32%
Employee	8.75%	8.75%	9.50%	9.50%
Total	*9.35%*	*11.39%*	*10.00%*	*11.82%*

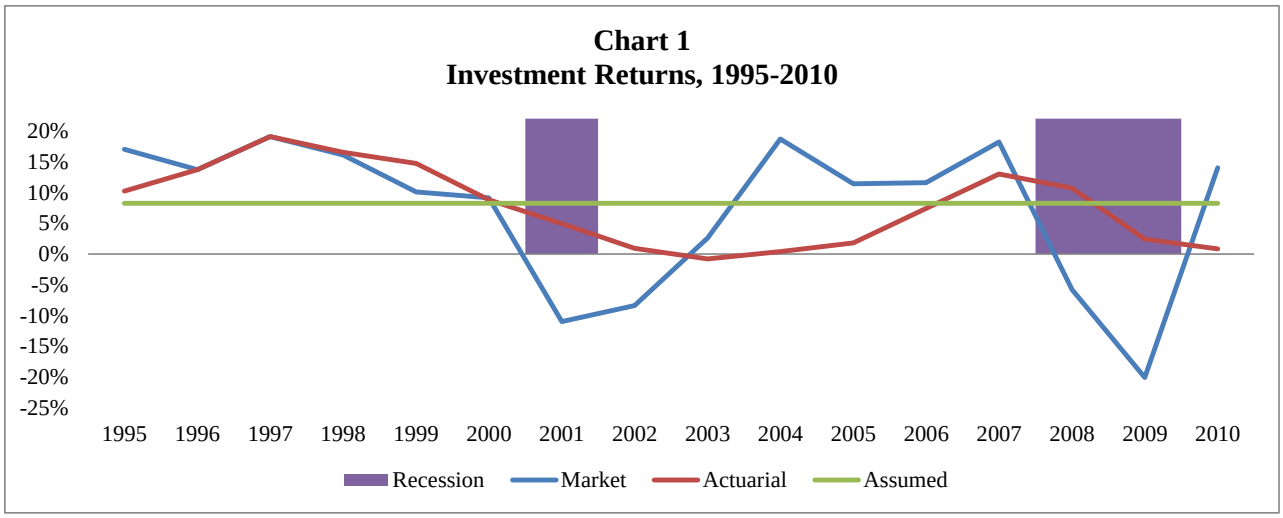
* The employer cost for teachers is shared between the state (40%) and local (60%).

SOURCE: ERSRI Actuarial Valuation as of June 30, 2010

Based on the most recent actuarial valuation (as of June 30, 2010), which incorporated the assumption changes recommended by the actuary and accepted by the Retirement Board, the total normal cost for state employees increased from 9.4 percent to 11.4 percent of payroll, a 21.8 percent increase, as shown on table 3. Employees are responsible for 8.75 percent of the normal cost, while the state's share increased from 0.6 percent of payroll to 2.6 percent of payroll. The total normal cost for teachers increased from 10.0 percent to 11.8 percent (an increase of 18.2 percent). Teachers are responsible for 9.5 percent of the contribution, while the employer share (split between the state and districts) increased from 0.5 percent to 2.3 percent of payroll. Because the employee share is set in statute and does not change when the assumed normal cost increases, any changes to actuarial assumptions that modify the normal cost will only affect the employer share.

Actuarial Value of Assets

The actuarial value of assets is the value of a plan's investments and property belonging to a pension plan at the time of the plan's valuation. Actuaries may use a number of different methods to determine the actuarial value of assets, often using a smoothing method that mitigates the effects of shorter-term market volatility. Smoothing allows for a more gradual recognition of investment gains and losses and acts as a financial "shock absorber". As is common across most pension plans, ERSRI uses a five-year smoothing method. As such, investment losses due to the recent market volatility are just being realized (chart 1).



Actuarial Accrued Liability (AAL)

The portion of the actuarial value of the PVFB attributed to past service (that is, service prior to the valuation date). While there are multiple methods to calculate this value, it reflects only the future benefit cost for past service. The AAL takes into account the actuarial assumptions outlined above. In contrast to the normal cost, the AAL also includes the benefit (or cost) of exceeding (or not meeting) assumptions for benefits obligated by past service.

As of the June 30, 2010 actuarial valuation, the total FY 2013 AAL for both state general employees and teachers was $13,238.9 million, an increase of 12.2 percent over the AAL prior to the changes made by the Retirement Board (table 4).

Table 4
Changes to Actuarial Liability and Value, FY 2013

	State		Teacher*	
	Before Changes	With Changes	Before Changes	With Changes
AAL	$4,651.2	$5,232.5	$7,151.0	$8,006.3
Actuarial Value	2,532.1	2,532.1	3,873.1	3,873.1
UAAL	*$2,119.1*	*$2,700.5*	*$3,277.9*	*$4,133.2*
Funded Ratio	54.4%	48.4%	54.2%	48.4%

* The employer cost for teachers is shared between the state (40%) and local (60%).

SOURCE: ERSRI Actuarial Valuation as of June 30, 2010

Unfunded Actuarial Accrued Liability (UAAL)

The UAAL is the dollar amount of benefits accrued for which no funds are set aside to cover. Specifically, it represents the gap between the actuarial value of assets and the AAL. Unfunded liabilities can occur, for example, 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 also increase the liability.

Table 4 shows the UAAL based on the June 30, 2010 actuarial valuation for state employees. As of that valuation, the UAAL was $2,700.5 million, a 27.4 percent increase compared to the UAAL prior to the Retirement Board changes. For teachers, the UAAL increased from $3,277.9 million to $4,133.2 million, an increase of 26.1 percent. These changes stem from an increase in the AAL, which was, in part, driven by the understated normal cost prior to the revisions.

Funded ratio

The 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. Most experts indicate that a funded ratio of at least 80.0 percent represents a relatively sound position for government pensions. It should be noted that private pensions are not permitted to fall under 80.0 percent without intervention. As shown on table 4, the change in assumptions resulted in an increase of the AAL, while the actuarial value of assets was not increased, thereby increasing the UAAL. For state general employees, the funded ratios dropped from 54.4 percent to 48.4 percent while the funded ratio for teachers dropped by a similar amount (from 54.2 percent to 48.4 percent).

Amortization

Simply, amortization is the payment of debt in installments over a period of time. The amortization of pension obligations reflects the decision to recognize unfunded pension costs over a period of several years. The amortization cost is the annual amount required to pay off the unfunded liability over the amortization period. Reamortization is a change in the terms of the repayment schedule. Currently, the state has 19 years remaining in its 30-year repayment schedule. If the state were to reamortize, it could extend the repayment period, reducing costs in the short-run and increasing costs over the long-term.

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. The ARC is calculated as the annual normal cost plus the amortization cost. 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.

Table 5
Contribution Rates and Estimated Contribution, FY 2013
($ millions)

	State		Teacher*	
	Before Changes	With Changes	Before Changes	With Changes
Contribution rates**				
Employer Normal	0.60%	2.64%	0.50%	2.32%
Employer Amortization Pymt	25.95%	33.70%	25.71%	32.93%
Employee	8.75%	8.75%	9.50%	9.50%
Total	*35.30%*	*45.09%*	*35.71%*	*44.75%*
Estimated FY 2013 ARC				
Employer	$182.5	$243.0	$282.8	$371.8
Employee	$60.1	$58.5	$102.5	$100.2
Total	*$242.7*	*$301.5*	*$385.3*	*$472.0*

* The employer cost for teachers is shared between the state (40%) and local (60%).

** As a percentage of payroll

SOURCE: "Actuarial Analysis of the Rhode Island Retirement Security Act of 2011, as described in S1111A and H6319A"; RIPEC calculations

Table 5 shows the contribution rates for the employer (employer normal cost plus amortization payment) and employee as a share of payroll, as well as the estimated FY 2013 ARC. The increase in the contribution rates reflect changes to actuarial assumptions made by the Retirement Board, as well as investment losses.

Although market instability has been a focus in pension debates, approximately 75 percent of change in employer cost related to changes in assumptions for state employees and teachers. The net effect of these modifications increased the estimated FY 2013 employer share of the ARC by 33.1 percent for state employees (to $243.0 million), and by 31.5 percent for teachers (to $371.8 million). As salaries were assumed to decrease slightly, the employee share, which is fixed in statute, is set to decline as well.

Benefits – Key Concepts

As with the financing of a retirement plan, there are a number of factors that are used to determine an employee's retirement benefit. This section provides an overview of key terms and examples of how benefits are calculated or affected by certain provisions of the current retirement systems in Rhode Island. The state has multiple tiers, or schedules, for retirement benefits as shown on table 6. An employee's specific benefit provisions will depend on how they are classified, which is determined by their hire, vesting or retirement eligibility dates. For the sake of simplicity, this report will refer to employees by their schedule as outlined below.

Table 6
Rhode Island Retirement Schedules

Schedule	Definition
A	Employees with at least 10 years of service by July 1, 2005
AB	Schedule A employees who were not eligible to retire as of September 30, 2009*
B	Employees who did not have 10 years of service as of July 1, 2005
B1	Schedule B employeees who were not eligible to retire as of September 30, 2009*
B2	Employees hired after September 30, 2009

* Based on the retirement criteria for their tier.

SOURCE: ERSRI Membership and Retirement Handbook, September 2010

Income Replacement

Central to the pension discussion is retirement security, part of which is the level of income that needs to be replaced in retirement for an individual to retain the same standard of living. The generally-agreed-upon range of income replacement is between 65 and 80 percent of income. This range varies with income levels – the higher a person's income is during their working life, the lower the share of income that needs to be replaced in order to be secure. Conversely, people with lower levels of income need to have higher income replacement levels to have income security in retirement. Sources of income replacement include Social Security benefits (for most employees), pension benefits or defined contribution payouts, and other savings.

Retirement Annuity

Defined benefit plans provide a guaranteed benefit, known as a retirement annuity, at retirement, based on a formula that incorporates a number of factors such as:

- *Final average salary (FAS):* the average salary (pay) over a specified number of years, often an employee's highest-earning years.

- *Years of service*: the length of employment as measured to determine eligibility, vesting and benefit levels. There is often a years of service requirement to be eligible to retire with full benefits.
- *Formula multiplier:* effectively, a percentage of the final average salary an employee earns for each year of service. Multipliers may be the same throughout an employee's working career or there may be graduated scales that increase with age or years of service.

For example, if an individual had 20 years of service, a FAS of $50,000, in a plan with a retirement factor of 2.0 percent, their retirement annuity would be:

(20 x 2.0%) x $50,000 = $20,000

As outlined above, Rhode Island has multiple tiers of retirement benefits that vary for employees based on hire date and an employee's eligibility to retire. The retirement annuity provisions for the different tiers are shown on table 7.

Table 7
Rhode Island State Employee Retirement Annuity Provisions

Provisions	Schedule A	Schedule B, B1, B2	Schedule A/B
Average Final Compensation	Highest 3 consec. years	Highest 5 consec. years	Highest 5 consec. years
Formula Calculation			
- Years 1-10	1.70%	1.60%	For Schedule A employees: all credits earned prior to September 30, 2009 are preserved. Future accrual of credits will be earned under Schedule B.
- Years 11-20	1.90%	1.80%	
- Years 21-25	3.00%	2.00%	
- Years 26-30	3.00%	2.25%	
- Years 31-34	3.00%	2.50%	
- Year 35	2.00%	2.50%	
- Years 36-37	-	2.50%	
- Year 38	-	2.25%	
Maximum Benefit	80.00%	75.00%	80.00%

Source: Employees' Retirement System of Rhode Island

As shown on table 7, the retirement annuity for a Schedule A employee who was eligible to retire as of September 30, 2009 with 30 years of service and a FAS of $50,000 would be calculated as follows:

[(1.7% x 10) + (1.9% x 10) + (3.0% x 10)] x $50,000 = $33,000

The retirement annuity for a Schedule B employee with 30 years of service and a $50,000 FAS would be calculated as:

[(1.6% x 10) + (1.8% x 10) + (2.0% x 5) + (2.25% x 5)] x $50,000 = $27,625

For all employees, the current system is back-loaded. That is, the formula multiplier increases with years of service. In contrast to plans where the formula multiplier is even over the course of a working career, back-loaded pension plans tend to encourage career employees and discourage job mobility. Back-loaded, evenly-distributed or front-loaded pension plans will attract a different mix of employees to the workforce. As such, the benefit accrual rate is an important factor to consider in plan design.

Service Credit Purchase

Participants may purchase service credit for eligible periods of public service or qualifying leaves of absence (e.g. military service, service as an elected official when no contributions were made to a pension plan, or prior service to a public schools system or local community). Purchase of service credit increases the years of service a plan uses to determine retirement eligibility and years of service. Service credit purchases typically do not affect vesting requirements. The cost of service is calculated through two methods:

- "Interest based" purchases determine the value of the contributions the member would have made had they been attached to the system during the period being purchased and then adding an interest rate. Prior to June 16, 2009, this was the system used for most service credit purchases in Rhode Island, with an interest rate set at five percent compounded interest.[1]
- "Actuarial cost" purchases are based on a member's age and years of service, multiplied by the member's salary at the time of purchase (or an average over a specified number of years). This method calculates the actual cost to the system of the service credit purchase. ERSRI members who wish to purchase service credit for time outside of the state or in non-participating cities must use this method of calculating their service credit. Effective June 16, 2009, this is the system used for all service credit purchases in Rhode Island with the exception of refund and military purchases.

Additionally, members in the military called to active duty during their employment (with at least six months of employment), who return to service within one year of honorable discharge, may receive up to four years of granted service credit in Rhode Island.

Vesting

Vesting is a timeframe in which an employee accumulates benefits. Specifically, after vesting, an employee has earned a non-forfeitable right to benefits funded by employer contributions. If an employee leaves employment prior to vesting, they forfeit their claims to accumulated benefits, but can withdraw the portion of their salary invested in a pension plan as employee contributions are 100 percent vested. The ERSRI currently has a 10-year vesting period for all employees, regardless of tier, which is among the longest vesting periods in the county.

Normal Retirement Age (NRA)

Generally, the NRA is the age at which an individual is eligible to retire and collect full benefits. In some systems there is an age requirement (e.g. 67 years of age as in the US Social Security System[2]), while in other systems, such as public safety, an employee is eligible for full benefits after a certain number of service years.

[1] NOTE: Purchased military service credit is based on the member's first year of earnings in the system and is only subject to interest charges if the purchase is made after the member's first five years in the system.
[2] For participants born after 1960.

The NRA for all state general employees is 62; however, Schedule A employees may retire at age 60 with at least 10 years of service, or after 28 years of service. There are no penalties for early retirement for Schedule A employees. Schedule B employees may retire at age 65 with 10 years of service, or 59 with 29 years of service. Although Schedule B1 and B2 employees may retire at age 55 with 20 years of service, their benefits are actuarially reduced from the NRA to compensate for the additional year(s) of payments. Reductions range from 34.9 percent of full benefits for employees who retire 10 years early (at age 55), to 89.3 percent of full benefits for employees who retire one year early.

Table 8 shows the effect of early retirement for a Schedule B1 employee with 20 years of service and a FAS of $50,000. If the employee retired at age 65, they would be eligible for a retirement annuity of $17,000. Retiring one year early, at age 64 reduces their benefits to 89.3 percent of their full benefit, resulting in a retirement annuity of $15,181, or $1,819 less than they would have received retiring at 65. Retiring at age 55 reduces their retirement annuity to 34.9 percent of the full benefit, resulting in an annuity of $5,933.

Table 8
Actuarial Early Retirement Factors*

Age	Age Factor	Full Benefit**	Early Ret. Benefit
64	89.3%	$17,000	$15,181
63	79.9%	17,000	13,583
62	71.6%	17,000	12,172
61	64.3%	17,000	10,931
60	57.9%	17,000	9,843
59	52.2%	17,000	8,874
58	47.1%	17,000	8,007
57	42.5%	17,000	7,225
56	38.5%	17,000	6,545
55	34.9%	17,000	5,933

* Applies to Schedule B1 and B2 employees
** Schedule B employee with 20 years of service at retirement and a FAS of $50,000
SOURCE: Employees' Retirement System of Rhode Island

Cost-of-living adjustment (COLA) provisions

COLAs for pension benefits are designed to ensure that the benefit does not erode over time due to inflation costs. These provisions vary among states, and may differ if states have multiple tiers or schedules for their pension systems. COLAs may be simple, in which the original benefit amount is adjusted, or compounded, in which the adjustment factor is applied to the total benefit (the original benefit plus adjustments).

In the current system, COLAs depend on the employee's schedule and eligible retirement date as follows:

- All Schedule A: 3.0 percent compounded, payable annually, starting the third January after retirement.
- Eligible to retire as of June 12, 2010, Schedule AB, B, B1, B2: The lesser of 3.0 percent or the urban Consumer Price Index, compounded annually after the third anniversary date of retirement.
- Not eligible to retire as of June 12, 2010, Schedule AB, B, B1, B2: The lesser of 3.0 percent or the CPI-U, compounded annually after the third anniversary date of retirement or age 65, *whichever is later*, limited to the first $35,000 of retirement annuities. The $35,000 limit will increase annually by the lesser of the CPI-U as of September 30 for the prior calendar year or by 3.0 percent.

Table 9 shows how retirement benefits would vary across the three systems for a hypothetical 61-year-old employee who retired December 31, 2010. In this example, the benefits are above the $35,000 threshold for employees not eligible to retire as of June 12, 2010 so the COLA is, in effect, a simple

COLA applied to the indexed COLA base. However, if benefits were below the threshold, the COLA would be applied to the entire benefit (a compounded COLA).

Table 9
Retirement Benefits with COLA by Schedule
Retirement Age 61, 12/31/2010

Year	CPI*	COLA Base	Schedule A		Eligible to retire 6/12/10 AB/B/B1/B2		Not eligible to retire 6/12/10 AB/B/B1/B2	
			COLA	Benefit	COLA	Benefit	COLA	Benefit
2010	2.5%	$35,000	$0	$0	$0	$0	$0	$0
2011	0.0%	35,875	0	50,000	0	50,000	0	50,000
2012	1.0%	35,875	0	50,000	0	50,000	0	50,000
2013	2.0%	36,234	1,500	51,500	500	50,500	0	50,000
2014	1.5%	36,958	1,545	53,045	1,010	51,510	0	50,000
2015	3.0%	37,513	1,591	54,636	773	52,283	563	50,563
2016	0.0%	38,638	1,639	56,275	1,568	53,851	1,159	51,722
2017	2.5%	38,638	1,688	57,964	0	53,851	0	51,722
2018	2.0%	39,604	1,739	59,703	1,346	55,197	990	52,712

* Hypothetical CPI index; the COLA base is adjusted by the prior year's CPI-U as of 9/30
SOURCE: ERSRI, RIPEC calculations

Disability Benefits

Workers who are disabled and no longer able to work are eligible for disability benefits, which are distinct from workers' compensation benefits. There are different types of disability retirement: ordinary disability, if the reason for disability is independent of employment, and accidental disability, in which the disability is causally related to employment. In Rhode Island, there are different standards for granting ordinary and accidental disability retirement per Rhode Island General Laws:

- Ordinary disability retirement: "the member is physically or mentally incapacitated for the performance of duty and should be retired." To qualify for ordinary disability, a member must have at least five years of service, three of which must be consecutive, and may not be eligible for a regular retirement annuity; and
- Accidental disability retirement: "the member is physically or mentally incapacitated for the performance of service as a natural and proximate result of an accident while in the performance of duty and should be retired. The disability cannot be the result of willful negligence or misconduct on the part of the member, nor can the disability be the result of age or length of service."

Benefits for members who retire on ordinary disability are equal to years of service and final average salary, and depend on schedule type. For members who are granted accidental disability retirement, and are found to be permanently and totally disabled, benefits are equivalent to sixty-six and two-thirds of the employee's annual compensation at the date of retirement. In the event that the member may work other jobs, the benefit is equal to 50.0 percent of annual compensation at the date of retirement. Cost-of-Living Adjustments are dependent on schedule type as outlined above.

Pension Reform

Funding retiree benefits for public sector workers is a national issue. Missed actuarial assumptions, such as mortality or discount rates (the investment target states expect to earn), have resulted in significant increases in the UAAL for most state and municipal plans around the country. In some cases, states have failed to pay their full ARC as a result of fiscal stress, increasing their future liability.[3] According to "The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Costs" by the Pew Center on the States, state pension payments (not adjusted for inflation) increased by 250 percent between FY 2000 and FY 2009. Over the course of one year, from FY 2008 to FY 2009, the number of states in which pension plans were less than 80 percent funded increased from 22 states to 30 states. As a result, states across the country have enacted broad pension reforms.

In general, changes to reduce employer cost modify: the components that go into calculating an employee's benefit (formula multiplier, maximum benefit, and final average salary calculation); retirement eligibility (age, years of service and disability); post-retirement benefits (COLAs); employee contributions; plan type; or the payment terms of the UAAL (reamortization). This section summarizes changes made around the country in the 2011 legislative session, provides a history of pension changes in the state, and highlights key aspects of The Rhode Island Retirement Security Act of 2011 (RIRSA).

Summary of Significant Pension Changes in 2011

According to a September 2011 report by the National Conference on State Legislatures (NCSL), 40 states have made revisions to their pension plans in 2010 or 2011, and 27 enacted significant changes in the 2011 legislative session, not including the recently-enacted pension reforms in Massachusetts. Highlights of the 2011 legislative session include:

Changes to Employee Contributions
Sixteen states enacted an increase in employee contributions in 2011. In most cases, all current employees were subject to the increase, although the increase only applies to new hires in Delaware, Hawaii and Montana. In some cases, as in Colorado and New Mexico, the increase in employee contributions is temporary. Although Texas did not pass legislation to increase employee contributions, the legislature acted to maintain member contributions, which were set to decrease.

Retirement Benefit Eligibility
Age and service requirements for normal retirement were increased in 15 states in 2011. Generally, the legislation only applies to employees hired after the legislation's effective date, but in two states – Connecticut and Maine – the legislation was applied to non-vested employees. Changes include increasing the normal retirement age or the minimum service credit an employee must earn to be eligible to retire early. Vesting requirements were also increased in eight states (Delaware, Florida, Hawaii, Maryland, North Carolina, Oklahoma, Texas and Wisconsin).

Retirement Benefit Calculations
The FAS calculation was increased in six states in the 2011 legislative session. Most states increased the period over which FAS is calculated from the highest three years (36 months) to the highest five

[3] NOTE: Rhode Island has contributed 100 percent of the ARC to the ERSRI since FY 1995 when the state's ARC payments were 66.0 and 81.0 percent for state general employees and teachers, respectively.

years (60 months). The FAS calculation in Florida was increased from the highest five years to the highest eight years. In all cases the changes only applied to new hires. Three states changed the rules governing types of compensation included in FAS calculations, generally to eliminate spiking (inflating compensation in the years preceding retirement in order to increase pension benefits). Delaware moved to eliminate overtime payments from FAS calculations while West Virginia enacted legislation to exclude all lump-sum payments. In Louisiana, compensation for a given year included in FAS calculations may not be more than 15.0 percent greater than the prior year's compensation.

COLA Provisions

Over the past two years, 18 states have made changes to automatic COLA provisions (10 in 2011 and eight in 2010). In three of the 10 states, changes to COLAs affect current benefit recipients, while only future hires are affected in six states. Oklahoma, which does not have an automatic COLA provision, enacted legislation requiring COLAs to be funded by the legislature at the time of enactment. In Arizona and Maryland, COLAs are linked to fund performance. The legislatures in Florida and New Jersey eliminated COLAs. In Florida, the changes only affect service earned on or after July 1, 2011. New Jersey eliminated COLAs for current and future retirees, while providing for a potential reactivation based on funding ratios.

Table 10
2011 Changes to Pensions and Retirement Plans

Changes in Employee Contributions:	Alabama, Arizona, Colorado, Delaware, Florida, Hawaii, Kansas, Louisiana, Maryland, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Dakota, Vermont
Retirement Benefit Eligibilty:	Arizona, Connecticut, Delaware, Florida, Hawaii, Maine, Maryland, Mississippi, Montana, New Hampshire, New Jersey, North Carolina, North Dakota, Oklahoma, Texas, Wisconsin
Final Average Salary Calculations:	Connecticut, Florida, Hawaii, Maryland, Montana, New Hampshire
COLAs:	Arizona, Connecticut, Florida, Hawaii, Kansas, Maine, Maryland, Mississippi, New Jersey, Oklahoma, Washington

SOURCE: NCSL "Pensions and Retirement Plan Enactments in 2011 State Legislatures"

Reamortization

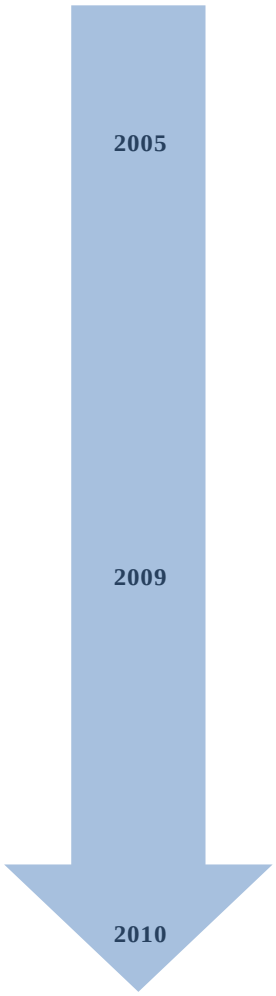
Three states made changes to their amortization schedule in 2011. Massachusetts extended their funding schedule by 15 years, from 2025 to 2040. The move is estimated to postpone payments of $800 million in the current fiscal year, but will have potential cost to the state of $30 billion between now and 2040. New Jersey enacted legislation that provides for a 30-year amortization period if contributions are paid in level dollars. When the amortization period reaches 20 years (July 1, 2028), the amortization period

will increase or decrease based on actuarial gains or losses. The North Carolina legislature acted to extend the amortization period for the Teachers' and State Employees' Retirement System, the Consolidated Judicial Retirement System, the North Carolina National Guard Pension Fund, and the Firemen's and Rescue Squad Workers' Pension Fund by three years (from nine to 12 years).

Recent Changes to Rhode Island's Pension System

Since 2005, the General Assembly has enacted three significant changes to the state's retirement system as shown in Figure 2:[4]

Figure 2
Changes to ERSRI, 2005-2010



Changes to retirement eligibility and benefit calculations for non-vested members (Schedule A and Schedule B); Instituted COLA delay

* Increased the minimum age and service requirement for early retirement
* Reduced the maximum benefit from 80% FAS to 75% FAS
* Modified the benefit accrual rate
* COLA delayed until 3 years after retirement

Changes to retirement eligibility, FAS calculation, service credit accrual and purchase, COLAs and disability for employees not eligible to retire as of September 30, 2009 (Schedule AB, Schedule B1, Schedule B2)

* Established age 62 minimum retirement age and instituted a methdology to actuarially reduce benefits for early retirement
* FAS calculation increased from 3 to 5
* Froze service credits earned as of September 30, 2009 and required all future service credit be earned under Schedule B
* Purchased credit may not count toward vesting and credit must be purchased at full actuarial cost
* COLA limited to the lower of 3% or CPI
* Disability status must be annually documented

Changes to COLAs for employees not eligible to retire as of date of enactment

* COLAs limited to the first $35,000 of retirement benefits

SOURCE: Rhode Island State Budget Office Documents, House Fiscal Staff Documents, NCSL Pension and Retirement Plans

[4] This report covers changes made to the Employees' Retirement System of Rhode Island, and does not specifically address correctional officers or nurses within BHDDH, although changes were made to all systems.

In 2011, the State's Retirement Board accepted the recommendations made by the state's actuaries Gabriel Roeder Smith & Company. The inflation assumption was lowered from 3.0 percent to 2.75 percent and the net investment return assumptions were lowered half a percentage point to 4.75 percent, lowering the nominal investment return from 8.25 percent to 7.5 percent. In addition, the life expectancy was increased for all groups. These changes, coupled with the phasing-in of investment losses over the past few years increased the states UAAL of $1,436.7 million (26.6 percent) to $6,833.6 million.

The Rhode Island Retirement Security Act of 2011

On October 18, 2011, the Rhode Island Retirement Security Act of 2011 (RIRSA) was introduced to the General Assembly. The revised bill was voted out of committee on November 10th and has been sent to the full General Assembly for a vote on November 17 (see the House bill, see the Senate bill). The Act – and revised bill – provide for a comprehensive restructuring of ERSRI with the intent of stabilizing the state's pension system and reducing future costs. In addition, RIRSA proposes changes to municipal plans that are administered by the state (MERS) including general employees and public safety employees, the Judicial Retirement Benefits Trust (JRBT) and the State Police Retirement Benefits Trust (SPRBT). Together, the changes are estimated to reduce the net state and local UAAL by $3.0 billion, and will reduce the FY 2013 estimated ARC payment by $302.2 million.

Table 11
Current v. Proposed State Pension Liabilities
FY 2013 ($ million)*

	Current ARC	Sub A2 ARC (DB/DC)	Change	Current UAAL	Sub A2 UAAL	Change
State						
State General Employees	$243.0	$141.6	-41.7%	$2,700.0	$1,701.9	-37.0%
Teachers - State Share**	148.7	83.1	-44.1%	1,653.2	955.7	-42.2%
JRBT	2.4	1.7	-29.2%	10.9	8.6	-21.1%
SPBT	6.0	1.8	-70.0%	28.5	7.3	-74.4%
Subtotal State	*$400.1*	*$228.2*	*-43.0%*	*$4,392.6*	*$2,673.5*	-39.1%
Local						
Teachers - Local Share**	$223.1	$120.4	-46.0%	$2,479.8	$1,433.6	-42.2%
MERS - General Employees	40.9	27.4	-33.0%	287.0	121.0	-57.8%
MERS - Public Safety	24.8	10.6	-57.3%	143.4	55.0	-61.6%
Subtotal Local	*$288.8*	*$158.4*	*-45.2%*	*$2,910.2*	*$1,609.6*	-44.7%
Total	**$688.9**	**$386.6**	**-43.9%**	**$7,302.8**	**$4,283.1**	-41.3%

ARC = Annually required contribution; UAAL = Unfunded actuarially accrued liability

* Estimated ARC payment and unfunded liability based on actuarial analysis

** NOTE: the actuarial analysis includes a slightly different contribution rate for state general employees and teachers when compared to the June 30, 2010 valuation. This table data included in the briefing.
SOURCE: "Actuarial Analysis of the Rhode Island Retirement Security Act of 2011, as described in S1111A and H6319A"; RIPEC calculations

For state general employees, teachers and municipal employees covered under MERS plans, significant changes were proposed in three primary areas:

- Shifting from a traditional DB plan to a hybrid plan with a reduced DB plan and a supplemental DC plan, and modifying benefit accruals, FAS calculations and retirement eligibility;

- Eliminating COLAs until all state-run plans (ERSRI, JRBT and SPBT) are 80.0 percent funded in aggregate, but allowing for a COLA-adjustment every 5th year dependent on fund performance, providing for an automatic suspension or reduction of COLAs when the funded ratio drops below 80.0 percent, and shifting the automatic COLA from a CPI-based formula to one dependent on investment performance; and
- Reamortizing the UAAL to 25 years (currently 19 years), and providing for a "laddered" reamortization, designed to smooth out future payments over time.

In addition to the changes listed above, personnel not covered by Social Security (SS) will have an additional DC allocation equal to 2.0 percent for both the member and employer for teachers and 3.0 percent for both the member and employer for public safety employees. The retirement age will be adjusted for all employees, with provisions to accommodate individuals near retirement. There are also provisions for public safety members that extend the normal retirement age and reduce the benefit multiplier (to 2.0 percent per year of service). The Act also makes changes to disability and service credit provisions.

Plan Design

Under RIRSA, all ERSRI employees will be moved to a hybrid plan, which will include a reduced DB plan and an additional DC plan. All employees will contribute 8.75 percent of their pay to retirement (a 0.75 percent reduction for teachers, no change for general employees). Of this amount, 3.75 percent will go toward their DB plan and 5.0 percent will go toward a newly-created DC account, which will be entirely portable. The state will contribute 1.0 percent to member DC accounts. Teachers that do not contribute to SS will have an additional 2.0 percent contribution to their DC plan, matched by their employer. The Office of the General Treasurer estimates that this will result in an income replacement rate of roughly 70 percent.

General employees covered under MERS plans will also be moved to a hybrid plan. Members will contribute 1.0 to 2.0 percent of their pay to their DB plan (depending on COLA election) and 5.0 percent of their pay to a DC account. Employees not covered under SS will have an additional 2.0 percent contribution to their DC plan, with an equal employer match. Public safety MERS employees will have a slightly higher contribution rate to their DB plan under the proposed legislation (7.0 to 8.0 percent, based on COLA election). For MERS police and fire without SS, there will be an additional 3.0 percent contribution to a DC plan with an equal employer match.

Judges and state police will not participate in the hybrid plan, primarily due to the unique nature of their work and terms of service. Specifically, judges' careers generally begin later in life and are shorter in tenure, while public safety employees tend to have shorter careers that end earlier in life due to the physical rigors of their jobs. Although their plans will not change, all judges will see an increase in their member contribution to 12.0 percent (from either 0.0 percent or 8.75 percent). State police will see an increase in their retirement age and a reduction in their benefit accrual to 2.0 percent per year. Accrual rates will be preserved for members of the state police with 20 years of service as of June 30, 2012.

Retirement Benefit Calculations

The legislation modifies future service credits for all current employees, while preserving already-earned service credits (as of June 30, 2012). Future service credits will be equal to 1.0 percent per year of service for general employees (state and MERS) and teachers, and 2.0 percent per year of service for

public safety employees. (NOTE: this does not affect judges, whose benefit will remain at 80.0 percent of the final five-year average pay). For example, a state general employee with 15 years of service as of June 30, 2012 would have accrued benefits equal to 25.0 percent of FAS. If the employee retired as of June 30, 2019, benefit accrual would be 32.0 percent (25.0 percent plus 7.0 percent). The employee would also have defined contribution benefits based on seven years of employer/employee contributions.

Final average salary calculations will also be modified under the proposed legislation, although FAS as of June 30, 2012 will be preserved and any changes will only be made when the new calculation is greater than the preserved calculation. Going forward, clothing allowances will be excluded for the FAS calculation for state police, although they will be allowed to continue count up to 400 hours of overtime. In addition, the FAS calculation will be extended to a five-year average for all employees, including MERS, although the three-highest consecutive year average as of June 30, 2012 will be retained as a minimum for benefit calculation purposes.

Retirement Benefit Eligibility

For state general employees, teachers and MERS general employees not eligible to retire, the normal retirement age is increased to the current Social Security Normal Retirement Age (SSNRA) of 67, or age 62 with 20 years of service with a reduced benefit. The retirement age and benefit reduction are applied proportionally to active employees, based on progress toward retirement (that is, by the employee's age and years of service relative to the SSNRA). Members may retire with benefits accrued as of June 30, 2012 at their current retirement date with their accrued benefit and salary for FAS calculations. To count any future service credits or future salary increases, the member must work until the revised retirement age (SSNRA or 62 with 20 years), modified by age and years of service. In addition, the vesting requirements for all employees will be reduced from the current 10 years down to five years for the DB plan, and three years for the DC plan.

All public safety employees will also see an increase in their normal retirement age to 55 with 25 years of service. Public safety personnel age 45 with 10 years of service as of June 30, 2012, currently eligible to retire at 52 will have an unreduced eligibility at age 52. State Police eligible to retire as of June 30, 2012, may retire at any time after their retirement allowance meets or exceeds 50.0 percent of average compensation and must retire when their retirement allowance equals 65.0 percent or they reach age 62. In the event that a member has not accrued a retirement allowance of at least 50.0 at age 62, they may continue work until they accrue a benefit of 50.0 percent of FAS.

COLA Provisions

Included in the legislation is a provision to suspend the COLA system-wide (state employees, teachers, public safety employees including state police, and judges excluding Supreme Court justices) until the plans are at least 80.0 percent funded in aggregate. The COLA will be reinstated for all employees when the plan reaches 80.0 percent, and will not decrease below 80.0 percent with the reinstatement of the COLA, but will be suspended or reduced in the event that the plan drops below 80.0 percent. The legislation includes a provision for COLAs to be paid every fifth year (commencing on plan year ending June 30, 2017), regardless of the funding level of the plan.

Additionally, RIRSA changes the current COLA calculation (the lesser of 3.0 percent or CPI) to one tied to investment returns for both current and future retirees. The proposed COLA would be equal to the

five-year average investment return of the retirement system (as determined by the last day of the plan year preceding the calendar year in which the adjustment is granted) minus 5.5 percent, not less than 0.0 percent nor more than 4.0 percent. That is, the five-year average return as of the June 30, 2013 valuation would determine the COLA for the 2014 calendar year for employees eligible for a COLA. The adjustment factor would be applied to the lesser of the retirement allowance of the first $25,000 of retirement allowance (indexed for inflation), a $10,000 reduction on the base in current law. For example, the assumed investment return of 7.5 percent would yield a 2.0 percent COLA, applied to the first $25,000 of a member's benefit (indexed annually).

Reamortization

The legislation extends the reamortization schedule to a closed 25 year schedule from the current 19. After the first five years, any actuarial gains or losses will be amortized over individual new 20-year periods. The reamortization is projected to further reduce the state's FY 2013 contribution by $26.9 million for state general employees and by $32.4 million for teachers ($13.0 million for the state, $19.4 million for districts). The state's actuary estimates that the proposed reamortization will cost an additional $1.8 billion (proposed provisions from a 19 year to a 25 year schedule). It would cost the state $7.2 billion to reamortize the current UAAL to a 30-year schedule from the current 19-year schedule with no changes.

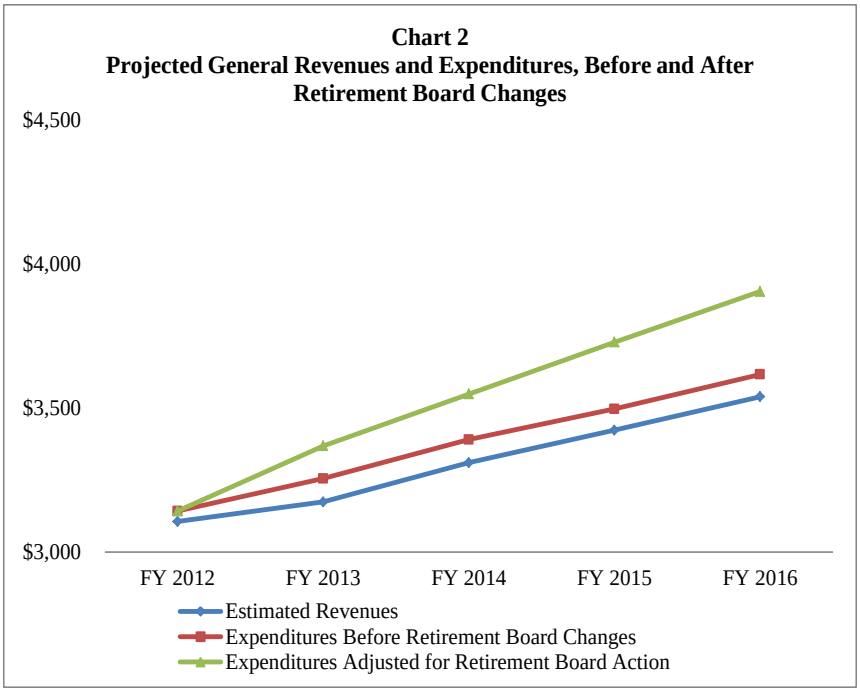
Locally-administered Plans

In addition to the above changes, RIRSA includes a chapter entitled "Retirement Security Act for Locally Administered Pension Funds", which affects the 36 locally-administered (non-MERS) plans in the state. As a group, these plans are 40.3 percent funded as of June 30, 2010 and have a UAAL of $2,096.4 million. Half of the locally-administered plans are less than 50.0 percent funded. By comparison, the roughly 110 pension plans under the MERS system are collectively funded at 73.6 percent, and have a UAAL of $430.2 million. The legislation:

- Creates a 14-member study commission charged with reviewing current pension and OPEB legislation and to make recommendations for the improved security and funding of locally-administered plans;
- Requires actuarial methods used in actuarial or experience studies, as well as for any changes to assumptions, to be in compliance with generally-accepted actuarial accounting rules and standards;
- Mandates that every locally-administered plan submit two plans to the study commission by April 1, 2012 – an initial annual actuarial valuation and an experience study – and requires the submission of an annual actuarial study to the study commission for each plan year within six months of completion. Subsequent studies must be submitted to the study commission no less frequently than once every three years. The state will reimburse 50.0 percent of the cost of the actuarial valuation study only;
- Establishes that a municipality must provide notification to participants, beneficiaries, the General Assembly, governor, general treasurer, director of revenue and auditor general if its funded status is deemed critical (less than 60.0 percent funded) within 180 business days following certification of the actuarial study;
- For plans deemed in critical status, requires municipalities to develop a funding improvement plan to be submitted to the study commission; and
- In the event that a municipal plan is not in compliance with this requirement, the state may withhold state aid other than education aid.

RIPEC Comments

The current pension system is on track to consume an ever-growing share of resources, inhibiting the state's ability to make strategic investments in Rhode Island's future, realign the state's tax structure, or fix the state's infrastructure. While these costs are not the only factors contributing to the state's structural deficit, these costs have a significant impact. Chart 2 shows projected revenues and expenditures for FY 2012-FY 2016, before and after the changes made by the Retirement Board. On average, the House Fiscal Staff estimates that the actuarial adjustments will increase the projected budget gap by roughly $80 million each year between FY 2013 and FY 2016.



Of note, a significant portion of pension costs are borne at the local level, exacerbating the state's already-imbalanced tax structure by putting additional pressure on the property tax to fund these liabilities. RIPEC's analysis of municipal pension obligations indicated that fully funding FY 2010 pension costs would have accounted for 14.3 percent ($290.7 million) of the statewide levy of $2,039.9 million. Based on revisions made by the Retirement Board, the local share for teacher retirement is projected to increase from $142.8 million in FY 2012 to $221.0 million in FY 2013 if no changes to the pension system are made, while communities in MERS are projected to see FY 2013 pension costs increase $32.6 million over FY 2012 pension payments of $33.1 million. Even if locally-administered plans did not increase their ARC payments, and all communities increased their levy to the cap each intervening year, local pension contributions are projected to total almost 20 percent of the statewide levy.

A consequence of funding these obligations without reform is "crowding out" spending on other programs or initiatives as pensions consume a larger share of revenues, or requiring an increase in revenues. Significant pension liabilities have played a role in recent municipal bond rating downgrades in Rhode Island and across the country, and were cited by Moody's Investor Services in their decision to downgrade the state's outlook from stable to negative. This, in turn, increases borrowing costs for much-needed infrastructure improvements and other capital expenditures at both the state and local level. High unfunded liabilities also may inhibit business growth and development as they put additional pressure on already strained revenues. This is a particular area of concern at the local level, where these costs are predominantly funded through property taxes, which are already some of the most onerous in the country – Rhode Island currently ranks 4th highest in the country for property tax burdens as a share of personal income.

How the state approaches the current pension challenge will affect a broad range of stakeholders, present and future. Clearly, pension reform will have an impact on current and future employees and retirees. However, there are many other stakeholders that are affected by the state's action or inaction with regard to pension reform. Individuals who rely on state and local services face potential service reductions, while taxpayers face an increase in their already-significant tax burdens. Moreover, decisions the state makes will have a lasting impact on the state's business climate as they will be reflective of the approach the state takes to governance. A proactive, principled, long-term approach will signal to businesses, taxpayers and employees alike that the state is dedicated to securing a stable – and sustainable – Rhode Island.

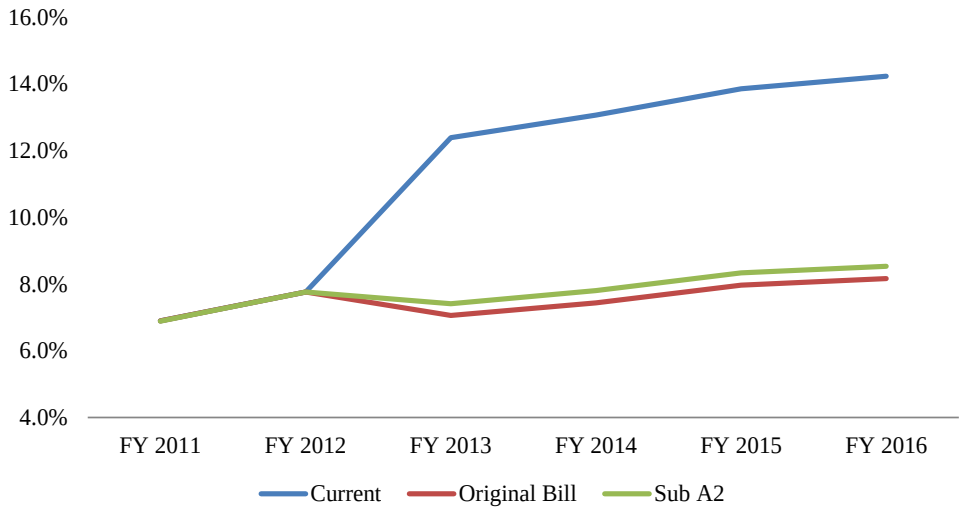
Principles to Guide Pension Reform

Pension reform is one of the most pressing issues faced by the state, at both the state and local level. The projected rate of growth is unsustainable, and even the current required contributions are out of reach for some communities. RIPEC has long-advocated for reform of the state's pension systems and believes that reform should be: sustainable, actuarially and legally sound, comprehensive, transparent and equitable. These principles are not mutually exclusive: a sustainable system is also an equitable and sound system, while an actuarially and legally sound system is also transparent.

Sustainability

State employees, teachers, state police and judges have been subject to a number of changes to their retirement plans since 2005 in an effort to rein in pension costs. Although these changes have reduced the cost to the state, they have not been enough to offset the effects of missed actuarial assumptions – particularly with regard to understated mortality rates – and poor market performance as a result of the economic downturn. Chart 3 shows the projected increase in ERSRI pension costs as a share of projected available general revenue. Pension costs under the current system are projected to account for an increasingly large share of the state's general revenue budget: while the state's pension contribution accounts for almost 7.0 percent of available general revenues in FY 2011, they are expected to account for more than double that share by FY 2016 – to over 14 percent of available revenues. Under either the original or the revised legislation, pension costs are projected to increase to between 8.2 and 8.5 percent of usable revenues in FY 2016.

Chart 3
ERSRI Pension Costs as a Share of Available General Revenues



The state and its municipalities cannot support the pension system in its current form, and changes at the margins will not result in

a sustainable system going forward. Stop-gap measures such as reamortization without comprehensive reform will only serve to ensure that the problem will be more difficult to fix in the future by increasing the overall liability without addressing the underlying issues. The proposed Act substantially reduces the unfunded liability and, thus, projected annual costs. As shown on chart 3, the state's annual payments under the proposed legislation would account for between five and six percent less than the current system in the out-years. While pension costs are still projected to increase over FY 2011 costs, the proposal puts the state on a significantly more sustainable track without forcing revenue increases or spending reductions in state and local government services.

Soundness

One of the primary factors contributing to the current status of ERSRI is the understating of the normal cost and reliance on unrealistic assumptions such as the too-high rate of return and understated mortality tables. Specifically, although the state has consistently met its ARC payments, these payments were artificially low because the assumptions understated the true cost of pension benefits. While the state has made an important first step in using more realistic assumptions, any reform must ensure pension plans are grounded in actuarially sound practices. The RIRSA includes a number of mechanisms that are designed to ensure fiscal soundness such as:

- Incorporating "trigger" mechanisms (such as the suspension of COLAs) that ensure the plans are self-correcting and are thus not subject to the political process going forward; and
- Requiring the Retirement Board to annually submit an annual report and financial statement of the plan to the governor, general treasurer, auditor general, speaker of the House of Representatives, and president of the Senate and requiring publication of a financial statement for plan members.

The changes must also be legally sound. There are nine states that explicitly prohibit public employee pension benefits from being reduced. Some of these states include New York, Illinois, Michigan and Texas. However, states that do not include such provisions in general law have also found themselves in court upon the passage of legislation that would alter retirement benefits for public employees. Colorado, Minnesota, New Hampshire and South Dakota have all seen legal challenges relating to changes in COLA provisions over the past few years. The cases, in general, center on whether COLA reductions violate protections afforded under the US Constitution – specifically the takings, contract and substantive due process clauses.

Several Rhode Island labor unions have filed suit alleging that the recent legislative changes to ERSRI are in violation of the contract and takings clauses. Specifically, that by creating ERSRI there was a contractual relationship between the state and participant. While Judge Taft-Carter dismissed the state's motion for a summary judgment, allowing the case against the state to go forward, the decision does not explicitly prohibit the state from moving forward with pension reform. As others noted, in order to find the statute violates the contract clause of the US and Rhode Island Constitutions, the court must find that:

- The statute violates an existing contract;
- The statute substantially impairs the contract; and
- The General Assembly did not have a legitimate public purpose for enacting the statute.

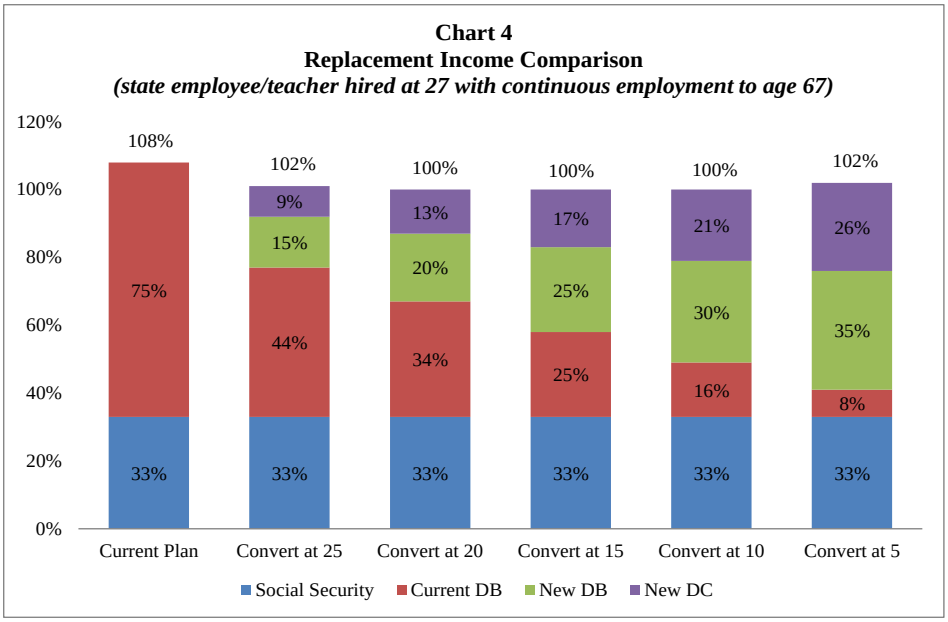
While there have been no decisions in either New Hampshire or South Dakota, the courts upheld the changes in Minnesota, noting that "statutes are not contracts absent plain and unambiguous terms that show intent to contract." It further characterized the legislative amendments in question as "a minimal

alteration in the calculation of future adjustments to retirees' annuities and a reasonable response to a fiscal threat that jeopardized the long-term interests of Plan members, the State and the State's taxpayers." In the justice's decision to dismiss the case in Colorado, a distinction was made between, "a retiree's contractual right to the base retirement plan benefits" and "a contractual right to a specific or particular COLA." Judge Hyatt ruled that "there is no contract right to a specific COLA formula frozen at retirement for life." This ruling appears to permit Colorado's legislature to make changes to the COLA at any time, even if that results in reduction to zero in a given fiscal year. The legality of changes to Rhode Island's pension system will, as in these cases, ultimately be settled by the Rhode Island Supreme Court.

Equity

Reform should also take into account the principle of equity. Specifically, reform must equally balance the interests and needs of current employees, retirees and taxpayers. All of the reforms since 2005 have been borne by non-vested employees or current employees not eligible to retire as of a specified date. While these reforms have resulted in savings of approximately $165 million, they have not generated enough savings to ensure the fund's solvency. It is clear that change must have a broader reach in order to ensure the long-term sustainability of the fund.

If no changes are made to COLAs for current retirees, a primary cost-driver of pensions, the state would need to adopt more significant benefit reductions for active employees and new hires, without any reduction in employee contributions for active employees. A large portion of current employees' contribution goes to support the unfunded liability of current retirees. The treasurer's office estimates that approximately two-thirds of the employee contribution goes to support this unfunded liability. Without making changes to retiree benefits, current employees will continue to support these costs, while participating in a plan that is currently projected to run out of money in as few as 30 years.



Shifting to a combination DC/DB plan allows current employees to support their own retirement, through a plan that continues to grow until retirement and is portable. Based on estimates by the treasurer, employees will still see income replacement rates that are higher than the recommended targets, although the particular sources of retirement income – and risk – varies based on years of service.

Employees closer to retirement would see the least increase in their risk (that is, the share of their benefits invested in a DC plan), while employees further away from retirement, with longer time-horizons for investment, will have an increased risk, but will still be assured of seeing replacement

income within the recommended guidelines. Further, the hybrid aspect of the proposal offsets the increase in the retirement age to an extent. The increase in retirement age would not prohibit an employee from retiring early, although the employee would face a delay in when they could collect without a reduction in benefits. Under a strict DB plan, the employee's retirement benefits would be set as of the date they leave state (or municipal) service; however, the portability aspect of the DC component would allow the employee to continue to contribute to their retirement, and their account would continue to accrue interest.

Another consideration is equity between the employee and the taxpayer. In contrast to the current system, where the risk is borne in its entirety by the employer, the hybrid aspect of the plan shares the risk between the employer and the employee, rather than placing the burden entirely on the taxpayer if assumptions or investment targets are not met. While revenues have recovered to an extent, it is clear that the state can ill-afford any significant increases in its tax burden, particularly at the local level. After years of declining, Rhode Island's tax burden as a share of personal income in FY 2009, the most recent year for which nationally-comparable data is available, increased to the 11th highest in the country, while the state's property tax burden as a share of personal income increased to the 4th highest in the country.

Comprehensiveness

Although achieving a sustainable level of pension contributions should be a primary goal of pension reform, pension system reform should be considered in the context of the overall human resource system. Changes such as shorter vesting periods, increased portability of benefits and a more evenly distributed benefit accrual rate may make the state's system more attractive to younger employees, who are less likely to be career employees. Similarly, changes that disproportionately impact younger or new employees may act as a deterrent to public service at a time when the state's workforce is greying. At the same time, pension systems that encourage longer terms of employment result in increased institutional knowledge and a more stable workforce. Moreover, the ability to attract and retain quality employees, particularly in hard-to-fill positions such as IT, requires a competitive and adequate compensation package. These competing interests must be taken into account when evaluating the merits of RIRSA or any other pension reform legislation.

Moreover, pension reform needs to be considered in the context of the overall budget, and the long-term goals of the state. The current pension system is a significant contributor to the state's structural budget deficit. In order to support the growing cost of retirement benefits under the current system, the state and municipalities must either make cuts to services or increase taxes. Historic revenue declines over the past few years have resulted in state and municipal budgets that were reactionary, as opposed to forward-looking. Four years of fiscal stress have resulted in a number of significant cuts to both grants and benefits and local aid. If there is no pension reform, or reforms do not go far enough to significantly reduce the current unfunded liability, these areas of the budget will continue to face additional cuts. While revenues appear to be recovering somewhat, continued pressure on the expenditure side – such as rapidly increasing pension costs – will continue to prevent governments from making strategic investments in their future.

In addition, the plan itself must be comprehensive, both in the short and long term. In the short term, the legislation provides for immediate fiscal relief relative to the current situation. The change to COLAs, along with accompanying safeguards, and the provision for COLAs every fifth year allow for the plan to

move toward a more secure funding status, while providing for adjustments based on the plan meeting its targets. The pension plan, as presented, also includes a number of elements designed to work in tandem. For example, the increase in the retirement age is balanced to an extent by the inclusion of a DC plan. Specifically, members may retire from public service prior to their retirement age, but may continue to supplement their DC plan, increasing their retirement benefits upon full retirement. At the same time, the hybrid plan shares risk between the employer and employee in the long run. The increase in risk-sharing for newer employees, who have a longer time-horizon for investments, ensures the long-term sustainability of the system, while preserving already-accrued benefits for employees closer to retirement.

Transparency

Finally, pension reform must be transparent. While part of this principle requires that participants and taxpayers are well-informed of the process, the changes and the impacts, transparency also requires that the system, in its final form, be transparent. Years of understating the normal cost both increased the unfunded liability and overstated the employee's proportion of the normal cost. The proposal as written includes a set of self-correcting mechanisms such as the risk-adjusted COLA, and triggers to effectuate further plan changes if the plans fall below pre-determined benchmarks, as well as the requirement that both state-administered and MERS plans must develop a funding strategy in the event the plan is severely-underfunded. The legislation also includes a mandated default mechanism in the event no agreement can be reached. These triggers are removed from the political process and require increased transparency in the process for all stakeholders.

The provision that locally-administered plans conduct actuarial valuations and experience studies is an important first step to increasing transparency at the local level. A number of these plans do not conduct regular plan valuations or experience studies and, as such, may rely on inaccurate or outdated actuarial assumptions, thereby over-stating the funded status of the plans. In addition, the requirement that municipalities must submit valuations to the study commission no less frequently than once every three years ensures these plans will continue to monitor and report their status. For funds in critical status, additional notification and reporting requirements provide an additional layer of transparency.

Transparency also relies on the ability of the state to clearly communicate the changes to plan members, while providing a long enough time-horizon for employees and retirees to make necessary adjustments. The sooner action is taken, relative to implementation, the better able the state will be to communicate the changes to members, enabling them to better respond to the changes. Delaying a decision will either shorten the time-horizon for members, or may increase the already unsustainable pension burden.

Principles of Pension Reform

***Sustainable**: reforms should be comprehensive enough to prevent the need for future revisions, and should ensure that taxpayers and employees are able to support the system without the need for increases in taxes or cuts to services; **Sound**: plan funding should be grounded in actuarially-sound practices so the funding of obligations is sufficient, and changes should be able to pass legal muster; **Equitable**: changes to the system should not unduly affect one class of employees over another, they should preserve what employees have earned, and risk should be borne by both the employer and employee; **Comprehensive**: pension reforms should not be undertaken simply as a cost-saving measure, but should be considered in the context of the overall budget and as part of a personnel restructuring process; and **Transparent**: changes and underlying assumptions should be clearly understandable to plan members and taxpayers, as should the need for plan changes.*

Looking Forward

The pension reform bill before the General Assembly represents a significant reform to state and local government operations and goes a long way toward reforming pension systems across Rhode Island. The suspension of COLAs for all retirees puts the system back on a sustainable path without requiring even more significant cuts for current employees, while the shift to a hybrid plan ensures that risk is shared between the state and current employees. Changes to the retirement age more accurately reflect mortality experience, and the addition of a DC plan component allows for retirees (or individuals who leave state service) to continue to accrue benefits through investment returns and individual contributions. These are fundamental changes to the cost and benefit structure for the state and MERS plans. However, only time will tell if these changes prove to be enough in the long-term.

At the same time, the ability of municipalities to support local pension obligations, both for plans in MERS and for locally-administered plans, represents a significant challenge for Rhode Island municipalities. As with the state plans, the question is whether the assumptions included in the legislation will hold up in the future, or whether there will be a need for future revisions. As RIPEC has noted, the status of locally-administered plans is of great concern. The legislation provides a positive starting point with regard to the requirement that actuarial valuations and experience studies be performed for these plans, as this will provide a clearer picture of the nature of the problem for locally-administered plans.

The concern is that these studies will show a much deeper problem than currently identified. For example, half of the plans currently use an assumed rate of return over 8.0 percent, while the average assumption across the plans is 7.8 percent; higher than the state's revised target, which is higher than recent experience. Similarly, communities that have not updated their mortality assumptions will face the same set of circumstances as the state. As noted in RIPEC's report on local pension and OPEB liabilities, 18 plans failed to meet 100 percent of their ARC payment in FY 2010 and to do so would, in many cases, would require a substantial, and potentially unaffordable, increase in funding. Of note, eight of the 18 plans that did not meet their full FY 2010 ARC are designated as distressed or fiscally stressed communities by the state.

If the locally-administered plans do, in fact, face the same challenges – or worse – than the state is currently facing, which RIPEC believes is likely the case, the issue of pension reform for locally-administered plans will ultimately be returned to the General Assembly for consideration and action. In this event, the following issues should be considered:

- Can local governments implement action plans, similar to the one the state is considering?
- Will local governments have the needed flexibility and means to accomplish fundamental changes, particularly with regard to requirements contained in the current collective bargaining statutes including binding arbitration?
- Do local governments have the ability to take unilateral action if negotiated settlements cannot be reached?

How state and local governments raise and spend money reflect policy choices. Currently, the state has a choice – comprehensively reform pensions or face significant tax hikes or cuts to services. Failing to act on the pension issue will likely force additional spending reductions after years of difficult decisions. This is particularly true at the local level. Cuts to state aid of over $200 million in the past few fiscal

years have placed increasing fiscal stress on communities that already face some of the highest property tax burdens in the country (4th highest as a share of personal income). While municipalities have absorbed those cuts, the projected increase in pension liabilities for many communities will force even further cuts to services or property tax hikes at a time when the state cannot afford to increase the resident tax burden. More importantly, the affordability and sustainability of the pension system will impact state and local flexibility with regard to responding to economic uncertainty and demand for government services.

The pension system, in its current form, is unsustainable. Marginal changes, or changes that simply push out the problem into the future such as reamortization or increasing the assumed rate of return, without comprehensive reform, will only serve to ensure that the problem will be more difficult to fix in the future. How the General Assembly response to the pension reform legislation before them will have a fundamental impact on the Rhode Island of the future. The legislation provides an opportunity for the state to comprehensively reform the state's human resource system into one that is responsive to the needs of the current workforce, while ensuring long-term fiscal sustainability. RIPEC believes the General Assembly needs to take action and approve the proposed reform legislation.