Commentary
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An Opportunity for Retirement Reform

LASERS proposal would benefit employees, retirees and the state

The Louisiana State Employees Retirement System, or LASERS, is proposing a Hybrid Retirement Plan for new state employees hired in 2020 and beyond. This plan would be an improvement for employees, especially those who spend only a part of their career in state government. It also would improve the sustainability of the retirement system by decreasing the risk of inadequate long-term funding while also strengthening cost-of-living adjustment provisions. It is a solid reform proposal that helps both state employees and state tax payers.

Senate Bill 14 by Senate Retirement Committee Chairman Barrow Peacock is the vehicle for the 2018 regular session. Based partly on hybrids used in states such as Ohio and Tennessee, the new Louisiana proposal would maintain a traditional defined benefit (DB) pension equivalent to Social Security and add a defined contribution (DC) annuity plan on top. The plan is for rank and file workers and would not apply to judges, hazardous duty positions or employees of other retirement systems, such as teachers.

A new plan for a new workforce

LASERS proposed the new plan to respond to the modern workforce, where fewer workers are keeping government jobs for most of their career. The system's analysis shows that only 5% of LASERS members will receive full unreduced benefits under the current plan. About 70% of new employees will get no benefits, only a refund of their contributions, because they will leave government service before qualifying for benefits under the current system. In other words, these employees essentially give the state an interest free loan. By giving the employees part of their savings in the form of a defined contribution account, shorter-term employees leave with something that can be used for their future retirement.

Main features and purpose

- Create an appealing private-sector style plan answering the trend of shorter-term state workers
- Provide easier portability and a more beneficial system to most employees
- Decrease the risk of the state accruing unfunded liabilities (UAL)
- Provide employees/future retirees a plan comparable with Social Security, which state workers do not have
- Provide pre-funded and more regular cost-of-living increases, which is better for both the employee/retiree and the taxpayer
- Eliminate the inefficient and unnecessarily expensive experience account method of cost-of-living adjustments for new employees

Current plan

LASER's primary retirement program is strictly a defined benefit plan with no Social Security allowed, placing the full risk of retiree accounts and benefits on the state and its taxpayers. Employees who leave their jobs with less than five years of service get zero of the state's investment portion. The current system contrasts to standard private sector retirement plans, which typically are a combination of guaranteed benefits under federal Social Security plus a 401(k) or other type of defined contribution plan.

Currently, for state employees covered by LASERs hired after July 1, 2006, the annual pension benefit is a calculation based on the number of years of service and the five best successive years of pay with the state. Those employees contribute 8% of pay and the employer contributes an actuarially determined amount (appx. 3.5%). The formula to determine a retiree's benefit is: (years of service) x (2.5%) x (average salary of 60 highest-paying successive months).

The inherent hazard with this type of plan is that the retirement benefits must be paid even if the retirement system investment portfolio is underfunded to meet those obligations. A fundamental problem with defined benefit plans in Louisiana and many other states is that they are way behind on meeting those goals and therefore have to make large annual payments toward the UAL to catch up. The real cost of a retirement system is how much the government and employees contribute for the normal costs, as noted above, plus the UAL payments. While the normal cost for LASERS this year will be $214 million, the UAL payment will be $637 million. The overall estimated UAL for LASERS is $6.8 billion. The state has been making its scheduled payments for LASERS and should continue to do so.

The proposed plan

The new system would provide a reduced version of the state's current defined benefit plan roughly equivalent to what they would receive under Social Security. In addition, employees would get a 401(k)-style defined contribution account. The proposed plan would provide disability and survivor benefits as under the current plan. The details of those two components of the plan are:

Defined Benefit Component:

- Employee contributes 4% of pay
- Employer (state agency) contributes actuarially determined rate (Appx. 2%, to be calculated)
- The new benefit formula is: (years of service) x (1.5%) x (average salary of 60 highest-paid months)

Defined Contribution Component:

- Employee contributes 4% of pay and employer contributes 3% of pay
- The employee can default to a low-risk fund or switch to a more advantageous 401(k) type individually managed account (There are state constitutional reasons for this structure)
- Annuity upon retirement, with an option for partial lump-sum payment
- The employee gets 50% of the state contribution after year two and is fully vested after year four

Also:

- Retirement eligible at age 65 for both components (instead of the current 60 or 62)
- Retirees would get a 2% cost-of-living increase every two years provided the system is 65% funded

A better system for cost-of-living increases

For years, PAR has been calling for prefunded cost-of-living adjustments (COLAs). This plan does just that. The current system of COLAs relies on so-called "excess" investment earnings deposited in an Experience Account. Created in 1992, the Experience Account provides no additional funding for COLAs, but rather serves as a drag on investments needed to fund guaranteed benefits. While the Experience Account system was improved in 2014 with Act 399, the core mechanism still exists. Louisiana is an outlier among states for using an Experience Account, a widely criticized method of managing COLAs.

This new plan would eliminate the Experience Account method for new employees. Instead, employers would set aside funds during the employees' career. These funds would be invested and grow along with other contributions. By paying the money upfront and allowing the money for COLAS to earn interest, the overall long term costs are much lower and the employee gets a more reliable system.

Time to stop kicking the can

As with any new retirement plan, policy makers would be wise to ask if it costs more or less than the current plan. According to the actuarial note on Senate Bill 14, this new plan will result in additional employer payments with a normal cost about 1% higher than the current plan. In the short term this will cost $2 million in 2021. As more employees join the new plan, the cost will ramp up to about $10 million more in 2031. For context, this would increase LASERS normal cost payment in 2031 from $605 million to $615 million.

In the long term this plan will save money because it makes the payments up front to properly fund the system instead of kicking the can down the road. For example, as mentioned above, instead of paying for COLAS by shaving investment gains from the retirement trust fund, the new plan would fund them over the working lifetime of the employee. That is why the actuarial note shows that the new plan by 2031 will result in $100 million lower retirement debt than the current plan. The overall long-term cost will be lower.

Risk shifting

With the current plan, if anything goes wrong with the financial outlook, the state is on the hook for the additional costs. Market losses, mistaken mortality assumptions, changes in policy from the Legislature, unfunded and unplanned COLAs, etc., are common examples of why the current system in reality ends up costing much more than anticipated. The state is taking 100% of the risk. The proposed bill reduces that risk with a smaller and better pre-funded defined benefit plan and by adding a 401(k)-style retirement account that would be in sync with market performance. However, this plan hardly shifts an unreasonable amount of risk to the employee. According to the actuarial note, the state will still bear more than 80% of the risk. Plus, the risk associated with the defined-contribution component is mitigated because when members retire, they will annuitize their accounts with LASERS. This will provide security to the employees in retirement. To address the concern that the annuities would create unfunded liabilities, LASERS has dealt with this issue by building in a hedge in their investment earning assumptions of 2.5%.

A strong step forward

The new plan will not solve all the problems with the retirement system. Existing unfunded liability payments must still be made so that the state can meet its obligations to the people in the current plan. In addition, PAR strongly recommends that the retirement systems use a more conservative investment assumption for the current plan and the proposed plan. However, this is a solid reform proposal that will help thousands of employees who receive virtually nothing toward their retirement for their time working for the state. It provides a more sustainable, prudent path by paying for eventual costs up front. It also will provide stable, predictable cost-of-living increases to retirees. Ultimately, if the burden of the state's annual UAL payments can be decreased with the help of this new plan, employees will be more likely to receive higher pay and better raises and COLAs. A plan that can do that should be given serious consideration by policymakers.

A not-so-minor footnote

Appropriate Normal Cost: The risk of generating an unfunded accrued liability can be reduced by making sure the normal cost of the plan is appropriate and adequate based on correct assumptions. The employer contribution toward the normal cost should cover administrative expenses, account for future COLAs and use a more conservative assumed rate of return on investments. By using a lower investment assumption for the proposed plan, a UAL would be less likely and would be smaller if it did occur. For example, a 7% expected rate of return would be a conservative improvement upon the current rate of 7.65% or the scheduled target rate of 7.5% in three years. Even if this lower rate only applied to the new hybrid plan, it would still be a significant achievement.

The main problems with the current retirement system stem from inadequately funding it on the front end, which results in a long and large accumulation of liabilities. This new plan is a chance to get it right and to fully pay the true costs of a retirement plan as we go rather than later when it will be more expensive.

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