PUBLIC EMPLOYEE RETIREMENT:

A Time for Change

ANALYSIS No. 306 March 2005

Executive Summary

The state's 40-year plan to pay off the unfunded accrued liability (UAL) of the pension systems and achieve 100% funding by 2029 is in deep trouble. Due to a backloaded payment schedule, added benefits and investment losses the combined UAL has ballooned from $6.1 billion to over $12 billion and will continue growing for another decade. Required annual payments on the UAL of the four state systems alone are projected to rise from $560 million in 2004 to $2.2 billion by 2029.

The combined funding level of all Louisiana systems plummeted from 89.8% in 2000 to 62.4% in 2003. The funding level of the major state systems combined was recently ranked fifth worst in the nation.

Taxpayers contribute $1 billion a year to help fund public employee pensions; yet the process for making retirement policy is haphazard, hasty, often ill-informed and prone to favor special interests over the public interest. Most pension legislation is passed in the last few days of the session leaving interested parties little opportunity to evaluate or comment.

The number of pension systems and sub-plans, combined with the relative independence of their member-dominated boards, makes pension administration complicated and costly. Even more costly is the impact on the benefit plans themselves. This fragmentation has resulted in large disparities in benefits for different employee groups and led to a leapfrogging of benefits as each group tries to equal or surpass what another has been granted.

Liberal eligibility requirements in the current plans encourage early retirements, increasing costs and promoting the use of DROP programs and the rehiring of retirees. Over the years, reform proposals have called for a new, second-tier system for new hires. A new system, it has been argued, could start with a clean slate; consolidate fragmented plans; offer uniform benefits for similar types of employees; reduce costs; and either revise unnecessarily liberal benefits or substitute an entirely different type of pension system.

Attempts to design a new pension system for future employees have floundered. The recent proposals, which have taken a variety of approaches, have not been adequately developed with a clear idea of the objectives and costs involved.

The problem of funding Louisiana's public employee retirement systems cannot be resolved overnight. However, enacting reforms now can help prevent the situation from spinning out of control in the future. This report offers a plan to deal with those issues that can and must be addressed now. PAR recommends:

- Vetting and prioritizing retirement bills prior to each legislative session.
- Slowing down the process of amending retirement bills
- Strengthening the committee that adopts actuarial assumptions
- Merging the four state systems and ultimately consolidating all systems
- Creating a consolidated system board with public members in the majority
- Consolidating the investment of all retirement funds in the state treasurer's office

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LIST OF ACRONYMS

COLA	Cost-of-Living Adjustment
CPR	Commission on Public Retirement
DB	Defined Benefit
DC	Defined Contribution
DROP	Deferred Retirement Option Program
LASERS	Louisiana State Employees' Retirement System
LFO	Legislative Fiscal Office
LSERS	Louisiana School Employees' Retirement System
ORP	Optional Retirement Plan
POB	Pension Obligation Bond
PRSAC	Public Retirement Systems' Actuarial Committee
ROR	Rate of Return
STPOL	State Police Pension and Retirement System
TRSL	Teachers' Retirement System of Louisiana
UAL	Unfunded Accrued Liability

- Creating an expert investment advisory board
- Reducing reliance on outside investment managers and building in-house staff
- Emphasizing passively managed investment (indexing)
- Making additional up-front payments on the UAL or, at a minimum, avoiding UAL increases and further backloading of the payment schedule
- Not issuing risky pension obligation bonds
- Providing automatic COLAs, funded by contributions, for retirees at age 65
- Creating a new defined benefit plan for new hires, setting a normal retirement age of 60
- Prohibiting new hires from participating in DROP or being rehired after retiring
- Offering new hires an optional defined contribution pension plan
- Lowering the 8.25% assumed rate of investment return, in line with economic projections

This report summarizes an extensive analysis of a number of major retirement policy issues: the retirement policymaking process; administrative structure; asset investment; funding and the UAL; pension obligation bonds; cost-of-living adjustments (COLAs); and, plan redesign options. The analysis focuses primarily on the major state systems and deals broadly with the seven issue areas selected as being of greatest concern. However, the recommendations have broader application to all 13 state and statewide systems.

Background

Public employee retirement in Louisiana is administered by 13 separate state and statewide systems. Four "state" systems cover state employees (LASERS), teachers (TRSL), state police (STPOL) and school employees (LSERS). The state guarantees the benefits for members of these four systems. Nine separate "statewide" systems cover assessors (ASSR), clerks of court (CCRS), district attorneys (DARS), firefighters (FRS), municipal employees (MERS-Plans A & B), municipal police (MPERS), parish employees (PERS-Plans A & B), registrars of voters (RVRS) and sheriffs (SPRF). In addition, ten local jurisdictions and agencies maintain their own systems. The systems were created at different times, for different employee groups, and with different benefits and funding arrangements. Each has its own member-dominated board responsible for administering the system and investing its assets. (See Table 1.)

All of the state and statewide systems have defined benefit plans that promise a certain percentage of final average compensation (typically the average of the 36 highest consecutive months) for each year of service. Contributions are required from both the employer and employee. Louisiana public employees are not covered by the old-age portion of Social Security, except for members of the B plans for municipal, parish and school lunch-room employees. However, all employees hired after 1986 are subject to the 1.45% social security medicare tax. The B plans are coordinated with social security, and as such, provide somewhat lower benefits and require lower contributions.

Policymaking Process

The number and variety of separate systems, subplans, retirement options, special interest groups and employers makes comprehensive pension policymaking extremely difficult. Numerous actors are involved in the policy process.

A member-dominated board controls each system's budget, sets its investment policies and grants COLAs.

Table 1. State and Statewide Retirement Systems Comparative Data

	Funding Progress as of June 30, 2003		Employer Contributions			Participants				
System	Funded Ratio	Actuarial Value of Assets ($millions)	FY 2004 Projected Contribution rate	FY 2005 Projected Contribution rate	FY 2003 Employee Contributions*	Active	Retirees	DROP Current	Total Members	% Active
State Systems										
LASERS (state employees)	59.7%	$5,853.0	15.80%	17.80%	7.50%	65,441	34,074	2,768	102,283	63.98%
TRSL (teachers)	62.4%	$10,738.1	13.80%	15.50%	8.00%	87,646	56,623	2,722	146,991	59.63%
STPOL (state police)	59.4%	$271.1	63.80%	59.60%	8.00%	948	1,096	45	2,089	45.38%
LSERS (school employees)	77.2%	$1,375.5	11.20%	14.80%	7.50%	14,486	10,129	792	25,407	57.02%
Total	**62.4%**	**$18,237.7**				**168,521**	**101,922**	**6,327**	**276,770**	**60.89%**
Statewide Systems										
ASSR (assessors)	59.5%	$107.2	14.49%	14.50%	8.00%	631	432	65	1,128	55.94%
CCRS (clerks of court)	67.8%	$206.8	14.32%	14.50%	8.25%	2,239	790	94	3,123	71.69%
DARS (district attorneys)	103.7%	$145.7	3.36%	3.75%	7.00%	676	200	5	881	76.73%
FRS (firefighters)	72.3%	$658.4	23.64%	24.00%	8.00%	3,360	1,351	120	4,831	69.55%
MERSA (municipal employees)	78.8%	$452.8	14.61%	15.00%	9.25%	5,331	2,564	202	8,097	65.84%
MERSB**	81.3%	$86.2	9.22%	9.50%	5.00%	2,007	783	57	2,847	70.50%
MPERS (municipal police)	77.4%	$1,076.3	21.75%	21.50%	7.50%	5,957	3,544	247	9,748	61.11%
PERSA (parish employees)	87.9%	$1,261.2	12.66%	12.75%	9.50%	13,607	4,922	327	18,856	72.16%
PERSB**	106.3%	$90.2	5.61%	5.75%	3.00%	2,154	481	35	2,670	80.67%
RVRS (registrars of voters)	91.5%	$43.9	7.80%	8.25%	7.00%	212	124	16	352	60.23%
SPRF (sheriffs)	81.9%	$907.4	9.61%	9.75%	9.80%	13,526	2,605	69	16,200	83.49%
Total	**80.2%**	**$5,036.1**				**49,700**	**17,796**	**1,237**	**68,733**	**72.31%**
Total All Systems	**65.5%**	**$23,273.8**				**218,221**	**119,718**	**7,564**	**345,503**	**63.16%**

*Regular plan only. Rates differ for sub-plans in some systems.
** Plan B is coordinated with social security
SOURCE: 2003 Actuarial Report on Louisiana Public Retirement Systems, State of Louisiana Legislative Actuary, Nov. 2004.

Of the 131 trustees on the 13 boards, only 36 are public representatives. The state treasurer is an ex-officio member of all the boards while the house and senate retirement committees have representatives on each of the state system boards.

The systems' staff and actuaries are the most knowledgeable persons in the state regarding their systems and are responsible for generating much of the technical legislation.

The legislative actuary advises the legislature, prepares actuarial notes projecting the cost of proposed retirement bills and prepares an annual report on the 13 systems. The annual reports have consistently criticized aspects of the pension plans and offered recommendations that, unfortunately, have been largely ignored.

The Public Retirement Systems' Actuarial Committee (PRSAC) was created to approve the assumptions that serve as the basis for determining the required contribution rates. This process quickly became political. At first, four actuaries were the only voting members. PRSAC now has seven voting members, four elected officials and three actuaries. An outside actuary member was recently eliminated.

An independent, outside actuary should be added back as a voting member of the Public Retirement Systems' Actuarial Committee (PRSAC). Actions should require approval by a super-majority vote (six of the eight members).

The Commission on Public Retirement (CPR) was created in 1991 and reconstituted in 2003. The 11-member body is charged with studying retirement issues and reviewing and prioritizing proposed legislation prior to the session. However, the new group met only twice in 2003 and, since then, not at all.

It is in the House and Senate retirement committees where the pension policy decisions are made. Typically, the chairman of one of those committees, for good or ill, has taken the leading role in pension policy. The committees may or may not conduct interim studies but infrequently develop legislation. There is no official joint retirement committee.

All retirement bills should be vetted by a re-energized Commission on Public Retirement and a Joint Committee on Retirement prior to introduction in a legislative session.

Legislative Policy Making

The volume and complexity of retirement bills filed each session severely strain the legislative decision-making process. Too often, decisions are made in haste without adequate information. The bills must be advertised twice before introduction but may then be amended—or completely rewritten—in either retirement committee, on the floor of either house or even in conference committee. Most retirement bills end up being adopted in the final days of the session. The process can leave interested parties little or no opportunity to review and comment on changes.

The highly reactive and piecemeal legislative process results in great variation in policy for different types of employees, encourages leapfrogging of benefits and renders across-the-board policy improvements nearly impossible to achieve. The policymaking system tends to favor special interests over the general public interest.

The 2004 legislative session was typical of the state's haphazard approach to pension policymaking. The House and Senate each unanimously approved bills taking totally different approaches to redesigning pensions for new state hires. One of these bills proposed a completely new type of pension plan yet had an incomplete actuarial note suggesting there would be long-range, multimillion dollar impacts that need to be examined. Another example of dueling bills was the misguided attempt to give 500 legislative employees an extra benefit that other state employees would not have. One version included a costly retroactive provision, but both were ultimately vetoed.

The immediate fiscal crisis was defused by backloading the payment schedules, and the legislature reasserted its right to approve state system budgets. However, proposals to redesign plan benefits were deferred in favor of study resolutions.

Hasty or complex amendments often leave no time for a revised actuarial note, which may be added after the fact. And, while a bill that lacks a revised actuarial note can be halted if a member objects, such objections are rare.

Short of prohibiting substantive amendments to retirement bills, legislative rules could be altered to provide serious speed bumps so that interested parties can react to amendments and the costs can be adequately reassessed.

Whenever a retirement bill is amended substantively on the floor, it should be recommitted to the retirement committee, and a definitive revaluation of the actuarial cost should be attached prior to reconsideration. In addition, a retirement bill should be required to lie over at least 24 hours following its amendment.

Dual-referral rules also need revamping. Currently only bills with a cost of $500,000 or more in one of three ensuing years are referred to the fiscal committees. Retirement bills with significant potential long-term costs may escape dual referral by not meeting the threshold.

Retirement bills with any projected cost to the state should have dual referral to the House Appropriations and Senate Finance Committees.

Administration

The number of pension systems and sub-plans, combined with the relative independence of member-dominated boards, complicates the administration of public employee retirement in Louisiana. This fragmentation removes opportunities to take advantage of economies of scale.

Comparing administrative costs with systems in other states is complicated by differences in system size, plan complexities and other factors. The Legislative Fiscal Office recently compared the operating expenses of TRSL with those of the million-member Texas Teachers Retirement System, whose $33-per-member cost in 2003 was about half that of TRSL's. While the comparison may not be entirely fair, it suggests that even Louisiana's larger systems may be missing out on some economies of scale.

At least six states, some much larger than Louisiana, have a single retirement system for nearly all state and local employees. Many of the states have only two major systems, one for educational employees and another for everyone else. Typically, consolidated systems include sub-plans for hazardous duty personnel.

Over the years, reports by PAR, the Legislative Auditor and a number of special study commissions have recommended consolidating Louisiana's pension systems to cut the cost of administration and to unify policy. During the 1970s, LASERS and TRSL absorbed separate plans for LSU academic and non-academic employees, judges, the Orleans teachers and school lunch employees. New statewide systems were created to merge local systems for municipal police and firefighters.

A merger of the state police system with LASERS was authorized but not implemented. Likewise, the merger of the system for school employees with TRSL has been discussed, but LSERS resisted the move due to its relatively better level of funding.

Consolidation alone is not a pension panacea. The differences in plans, funding levels and funding sources would complicate a merger. Even if a single new system were created for all new hires, each of the existing plans would have to be continued until the grandfathered employees and their survivors received their final checks. Furthermore, administrative costs are a relatively small portion of pension costs.

The fragmentation of public pension plans has undoubtedly added to administrative costs, but more significantly it has added to the costs of the benefit plans themselves. The fragmentation has led to large disparities in benefits for different groups of public employees and an inevitable leapfrogging of benefits as each group tries to equal or surpass what another group has been granted. Achieving uniformity in the future requires action now.

The state's long-run goal should be to create a single consolidated pension system for all state and local employees with separate plans for teachers, hazardous duty personnel and all other employees. The first step should be to merge the administration of the four state systems.

A majority of the members of the consolidated system board should represent the public at large.

Investment of Assets

Over the last two decades, the larger systems have vastly expanded their use of outside money managers and advisors. TRSL alone currently lists some 70 money managers including specialists in a variety of investment types. Similarly, LASERS has some three dozen contracts.

In general, the investment programs of LASERS and TRSL are similar to those of their peers in other states. Most large public pension funds depend heavily on outside managers to actively manage their assets. However, LASERS and TRSL are on opposite ends of the spectrum in terms of active and passive management strategies. Nearly all TRSL assets (98%) are under outside management, and 93% are actively managed. TRSL has an unusually high percentage (nearly 15%) of its assets in alternative investments. These are direct investments in businesses and venture capital situations that carry relatively high risk and high potential returns.

LASERS, on the other hand, has recently moved to increase its in-house investment capacity. Roughly a third of its assets are internally managed and nearly 40% of its assets are passively managed including some under external management. Only about 5% of its assets are in alternative investments. Despite the difference in investment approaches, the one-year returns for fiscal year 2004 were remarkably similar, 18.2% for TRSL and 18% for LASERS.

Comparing costs and investment returns among different pension funds is not simple nor necessarily accurate. Different approaches and asset allocations will perform differently over different periods. However, logic suggests that, over the long run, active management of publicly traded stocks and bonds will not beat the market. Indexing (passive investing) attempts to duplicate the market by buying the same stocks or bonds included in an index such as the S&P 500. Indexing obviously cannot beat the market, but neither will it underperform the market.

A June 30, 2004, report by the TRSL advisor RVKuhns indicates that the prior ten-year average return rate (9.9%) for 50 large public systems was a half percentage point below the 10.4% return that would have been gained by indexing 60% on the S&P 500 and 40% on the Lehman bond index. (See Table 2.) TRSL's very actively managed fund fell a full two percentage points short of that simple benchmark. However, its most recent one-year return (18.2%) far outpaced the 11.3% index return for the last year.

A 2003 Legislative Fiscal Office (LFO) report compared the active investment strategies and use of outside managers by LASERS and TRSL with the Texas teachers' system's use of in-house staff and passive management. The Louisiana system's investment costs were much higher to achieve about the same returns.

The LFO report covers an atypical period, does not account for differences in expense accounting and makes a comparison with a pension system triple the size of all Louisiana systems combined. Still, the comparison appropriately suggests potential cost advantages of the report's recommendations to pool assets, consolidate in-house management (preferably in the treasurer's office) and emphasize indexed investing.

Past PAR reports have made the same recommendations. The office of treasurer is the obvious place to locate a consolidated investment program for the systems' funds. The treasurer is a statewide elected official,

The following is a comparison of returns on investments by 77 of the largest public retirement funds in the nation. RVKuhns & Assoc., Inc. prepared the report for TRSL.

Over the long haul, TRSL's returns fell just short of the benchmark and of the median for the 50 funds that reported 10-year data. However, only one-fifth of the funds beat the 10-year benchmark, and then by very little. Superficially at least, this seems to suggest the benefits of passive indexing over the long run.

Table 2. Annualized Total Fund Returns
(Periods ending June 30, 2004)

Period	#Funds Reporting	Median – all funds	Benchmark*	TRSL	TRSL rank	LASERS**
1-year	77	16.5%	11.3%	18.2%	13	18.0%
3-year	77	4.5%	2.5%	3.9%	62	5.1%
5-year	76	4.0%	1.8%	4.2%	30	3.9%
10-year	50	9.9%	10.4%	9.6%	35	N.A.

Source: RVKuhns & Associates, Inc., TRSL Performance Report, Sept. 30, 2004
* Benchmark is a combined index of 60% S&P 500, 40% Lehman Aggregate.
** LASERS, Summary of Manager Performance, rates of return gross of fees.

The important thing for TRSL was that it beat the benchmark by a wide margin over the past five years. It fell off more than the median fund in the downturn and gained more in the upturn. This may be related to the fund's relatively high-risk asset allocation. According to TRSL calculations, its active management strategy added $1.3 billion in investment earnings during the five year period ending February 29, 2004.

who is accountable to the voters and bears the constitutional responsibility for the safekeeping and investment of the state's funds.

Responsibility for investing all of the assets of the state and statewide systems should be consolidated in the office of the state treasurer.

An expert investment advisory board should be created to advise the state treasurer.

The reliance on outside investment managers and advisors should be reduced, and the capacity for in-house management strengthened.

The investment policy should emphasize passive management and indexed investments.

Investment Limits

Initially, the law specified the types and amounts of investments that were allowed. More recently, the "Prudent Man Rule" was extended allowing systems to invest as a prudent person might in a similar situation. However, the law continued to limit the percentage of assets a system could invest in stocks.

Last session, the legislature extended the 65% equity limit to all systems, if 10% of the equities were indexed. An unsuccessful attempt was made to require the state systems to manage 25% of their assets internally, and several bills dealt with the relationship between system trustees and investment managers or advisors.

A 2003 session act required systems to use in-state broker-dealers to place 20% of their equity and bond trades. It also required plans for investing venture capital in the state. While this was a two-year pilot program, it represents an inappropriate level of legislative micromanagement.

The "Prudent Man Rule" should be the sole investment guideline without additional statutory restrictions or limits. Legislative micro-managing of investment strategies should be avoided.

Role of the Assumed Rate of Return

The assumed long-term rate of return on investments was raised from 7.5% to 8.25% for LASERS and TRSL in 1991, largely as a budget-balancing gimmick to cut UAL payments that year by $108 million. The rate for the state police and school employees' systems remained at 7.5%. Nationally, 8% has been common, although many systems have lower assumed rates.

The 8.25% rate is important to the LASERS and TRSL boards, because half of the amount earned above this rate (the so-called excess earnings) goes into an "experience account," which the board uses to fund COLAs for retirees. Thus, there is an incentive to accept a relatively high level of investment risk.

The Public Retirement Systems' Actuarial Committee should lower the 8.25% assumed rates of return for the major state systems in light of current projections of long-run investment returns.

Funding and the Unfunded Accrued Liability (UAL)

In 1987, Louisiana approved a plan to pay down the then existing unfunded accrued liability (UAL) of the public employee retirement systems and achieve full funding for all of them by 2029. An imperfect implementation, additional benefit increases and the recent asset losses due to the market downturn have resulted in a growing UAL and an increasingly backloaded payment schedule.

The funding ratios (assets/accrued liabilities) vary widely among the state and statewide systems, from a low of 59.4% to a high of 106.3% in 2003. Unfortunately the two largest state systems, which cover nearly three fourths of all public employees, have funding levels on the low side; LASERS was only 59.7% funded, and TRSL was at 62.4% in 2003. A recent Wilshire report ranked the combined state systems' funding level the fifth worst in the nation. All Louisiana systems combined were funded at 65.5% in 2003 down from a high of 89.8% in 2000.

The unfunded portion or unfunded accrued liability (UAL) now totals over $12 billion for all 13 systems, up from $10.5 billion in 2003. The UAL in the state systems will continue to grow through about 2015, because payments on the initial UAL (as of 1989) will not even cover the interest on the debt until then. Benefit increases and actuarial losses have also contributed to the UAL growth. In the 2004 session another $1.7 billion was added to the state systems' UAL to reflect investment losses, bringing the total to well over $11 billion. Required payments on the UAL of the state systems were projected to rise from $560 million in 2004 to $2.2 billion by 2029. (See Figure 1.)

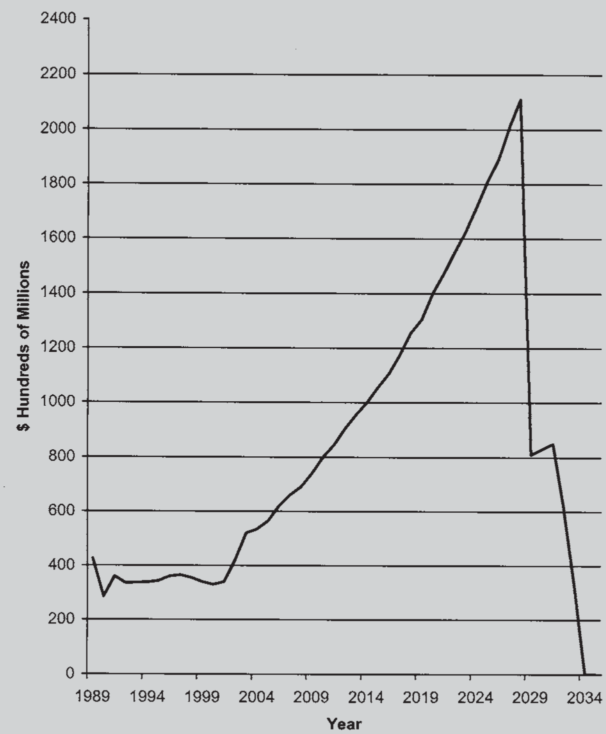

Figure 1. Backloaded UAL Amortization Schedule for LASERS and TRSL Combined

Act 588 of 2004

For FY 2005, the state and school districts faced major increases in the required employer contributions to the state systems. Retirees faced the prospect of not having another COLA funded. Act 588 of 2004 took several steps to deal with these issues. First, the act re-amortized portions of the UAL in the three major state systems (TRSL, LASERS and LSERS) to temporarily lower the required employer contributions by $100 million for FY 2005, which added $3.8 billion in future interest costs.

Secondly, the act eliminated the negative balances ($1.7 billion combined) in the TRSL and LASERS COLA accounts ("experience accounts") by increasing the UAL of those systems. This allowed the accounts to again begin accumulating funding for COLAs. The act continues to divert half of any "excess" earnings of the systems to the COLA accounts.

And, finally, the act created a 15.5% floor for employer contributions to LASERS and TRSL. If the actuarially required contribution rates fall below 15.5%, the extra funding will go into an Employer Credit Account to be applied against the UAL.

Funding Options

There is no "silver bullet" solution for dealing with the growing UAL payment problem. The four major funding options are to 1) make additional up-front payments, 2) stretch out the payment over a longer period, 3) issue pension obligation bonds, or 4) continue as is. Each has its drawbacks.

Make additional payments up front. The state has been making substantial payments on the UAL, but it has postponed the really heavy lifting for the next generation of taxpayers. Putting up additional funds now would be politically difficult, but it would ease the future burden. An additional $100 million payment a year on the UAL would apparently save the state nearly $4 billion over time. The only potential added funding currently contemplated, however, might result from the 15.5% floor on employer contributions that was enacted last year.

Stretch the payments over a longer period. Whereas Louisiana set a 40-year fixed period to pay down its initial UAL, a number of other states use rolling amortization periods of 30 or even 40 years. However, a rolling 30-year amortization only makes sense if each annual payment is the first of 30 level-dollar payments as recomputed each year. With 24 years to go on a heavily backloaded payment schedule, the state would now have to pay much more on a new level-dollar, 30-year schedule. However, as the current payment schedule rises and 2029 gets closer, this option will certainly receive more consideration.

Issue pension obligation bonds (POBs). The idea of selling bonds at 6%, investing the proceeds at a much higher rate of return and eliminating a UAL debt that bears an 8.25% interest rate is appealing. However, the most obvious drawback is that earnings might not exceed the bond interest rate over the long run. Another run of market losses could be devastating.

While an $11 billion bond issue could eliminate the state system UAL, it would be replacing a soft debt with a hard debt. This could adversely affect the state's bond ratings. Another problem is that a level-dollar payment on an $11 billion bond issue would currently require $300 million more a year than is now being paid on the UAL due to a backloaded payment schedule. Thus there would be an incentive to backload the bond payments. An additional problem would be the likelihood of political pressure to increase benefits once the system were fully funded.

The high risk involved makes issuing pension obligation bonds inadvisable.

Continue the existing payment schedule. While the UAL payments are ramping up to over $2 billion a year, inflation and economic growth will make the real increase slightly more manageable. There might be future windfalls, which could be applied to the UAL to reduce the payments in the final years of the amortization.

THE STATE SHOULD INCREASE ITS UP-FRONT PAYMENTS ON THE UAL. WHILE THIS IS THE PREFERRED COURSE OF ACTION, AT A MINIMUM, THE STATE MUST AVOID FURTHER BACKLOADING THE PAYMENT SCHEDULE.

THE LEGISLATURE SHOULD AVOID ISSUING PENSION OBLIGATION BONDS, GRANTING ADDITIONAL BENEFITS OR TAKING ANY OTHER ACTIONS THAT MIGHT INCREASE THE UAL IN THE FUTURE.

Cost-of-Living Adjustments

Without COLAs, a benefit of 75% of final average compensation five years ago would be worth 66% today. Over the last 20 years the 75% benefit would have fallen to 41%. While COLAs are not automatic for retirees of the state systems, the legislative actuary reports they have been receiving a weighted annual average COLA of 1.3%, or about half the 2.8% increase in the consumer price index (CPI).

Louisiana has never found an adequate solution to the question of how to provide COLAs. Earlier COLAs were sometimes provided using appropriations. Often they were not adequately funded, thus increasing the UAL. More recently, the state and statewide system boards were authorized to grant COLAs from "excess" investment earnings.

Experience accounts were created for TRSL and LASERS to provide a source of funding for COLAs. The accounts were credited with half of any "excess" earnings the system received on its investments above the 8.25% assumed rate of return. When the account reached a certain point, the board was required by law to grant a COLA. The funds in the account were then placed back in the system's fund.

While the experience accounts were credited with half of the investment gains, they were also to be debited with half of the investment losses. Thus, the recent market crash created a $1.7 billion negative balance in the two experience accounts. It would have required many years of excess earnings to again create a positive balance.

COLAs have differed as to benefit ceilings, minimum benefits, equal dollar payouts, service requirements, age and years retired. A costly element of COLAs has been the typically liberal eligibility requirements. Because the pension plans do not have a realistic normal retirement age and most allow very early retirement, retirees can easily collect benefits for longer than they worked. Giving persons COLAs soon after retiring in their fifties is more costly than applying a reasonable age and service requirement. LASERS and TRSL retirees now must simply have received benefits for one year and be 55 years of age to get a COLA.

Act 588 of 2004 removed the $1.7 billion deficit from the LASERS and TRSL experience accounts and limits them to accumulating enough "excess" earnings to fund two 3% COLAs. However, it is not expected that earnings will be sufficient to pre-fund a COLA for some time in the future, if ever.

At any rate, the argument that retirees should share in "excess" investment earnings because they pay half of the contributions is simply illogical. The actuarial rate of return is an average, and skimming the fund in the good years leaves nothing to offset losses in other years. When earnings fall, the state, not the employee, bears the risk and must make up the difference.

THE STATE SHOULD DEVELOP A REALISTIC, AFFORDABLE, PREDICTABLE AND CAREFULLY DEFINED COLA POLICY FOR ITS STATE RETIREMENT SYSTEMS. COLAS SHOULD BE PROVIDED ONLY TO RETIREES WHO HAVE REACHED AGE 65.

THE EXISTING EXPERIENCE ACCOUNTS SHOULD BE ELIMINATED, AND PLANNED COLAS FOR EXISTING RETIREES SHOULD BE FUNDED THROUGH EMPLOYER CONTRIBUTIONS, WHILE PLANNED COLAS FOR ACTIVE EMPLOYEES SHOULD BE FUNDED BY BOTH EMPLOYER AND EMPLOYEE CONTRIBUTIONS.

Benefit Plan Redesign

Public retirement reform proposals over the last several decades have consistently called for a new, second-tier system for new hires. A new system, it has been argued, could start with a clean slate; consolidate fragmented plans; offer uniform benefits for similar types of employees; reduce costs; and either revise unnecessarily liberal benefits or substitute an entirely different type of pension system more in keeping with modern employment trends.

There are, however, some basic realities that must be recognized in undertaking a plan redesign. Most important is the fact that no change in the benefit plans will reduce the existing UAL costs. Any possible savings will only develop in the future, because, due to constitutional and practical limitations, the new plan would only apply to future hires.

Another important consideration is that any change involving the addition of social security coverage (12.4% of payroll) would be prohibitively costly. If Louisiana lost its exemption from social security, it is estimated public employers would pay an added $1.5 billion in the first five years. Most of the state's defined benefit plans must provide retirement and replace social security as well. As a result, they have assumed a social welfare role not present in pension plans in most other states. This role cannot be ignored.

In redesigning a pension plan, the major options are a defined benefit (DB) plan or defined contribution (DC) plan. A DB plan promises certain benefits. Employer and employee contributions are made as the benefits are earned. These funds together with investment earnings pay for the benefits. The DC plan promises certain contributions by the employer, which together with employee contributions are invested by the employee. The retirement benefit is the final balance in the individual's account, which can remain invested, be spent or be used to purchase an annuity.

All Louisiana pension systems have primary DB plans. There is one Optional Retirement Plan (DC plan) for some political appointees and another for higher education professionals. All employees can also invest tax-deferred income in a supplemental Deferred Compensation Plan, however the state does not contribute to this. TRSL recently created a hybrid plan (half DB and half DC) at the legislature's insistence but had no takers.

Arguments for Defined Contribution Plans

The DC plan has a number of advantages for an employer. It can be less costly and simple to administer. The contribution rates are fixed, and all of the investment risk and cost is shifted to the employee. Costly benefits for survivors and disability can be omitted. Also, there are no unfunded liabilities to worry about.

Advocates for DC plans also cite advantages for the employee. The employee can invest his own funds. The funds are portable, and there is no penalty for short-timers as there is in a DB plan. There is greater access to the funds, and lump-sum distributions may be taken. The funds remain after death and can be passed on to heirs.

Unfortunately, the characteristics of a DC plan that are favorable to some employees can be disastrous for others.

Defined Benefit Plan is Best Fit for Louisiana

Nearly all states use DB plans as their primary pension plans. A DB plan is the appropriate vehicle for providing most public sector pensions. It encourages career employment, and public employees are less mobile than private sector workers. The DB plan can provide better benefits than an equally funded DC plan, because a pension system can spread risk and invests more effectively than most individuals, who tend to invest more conservatively. The DB plan provides security, whereas a DC plan, particularly one without social security participation, would leave employees vulnerable. Recent studies show that employees tend to cash out DC accounts, fail to reinvest with their new employer's plan and spend lump-sum distributions, leaving them with much reduced retirements. The DC plan serves well for certain short-term positions and as a supplement to a DB plan, but is inadequate as a general primary pension plan.

A DB Plan for the Future

The existing state DB plans are not well designed to meet current, much less, future needs. The basic problem is the lack of a reasonable "normal retirement age" and the early retirement options that allow a person to retire before reaching the end of a productive career. State employees can take a "full career" retirement at any age with 30 years service or at age 55 with 25 years. The costly early retirement benefits have also resulted in double-compensation provisions: the deferred retirement option program (DROP) and the rehiring of retirees to keep people on the job. In addition, these liberal benefits have made it more difficult to establish a rational policy for funding COLAs.

The state's DB plans now use an average compensation based on the employee's highest 36 months to figure benefits. A longer period, such as 60 months, would reduce the impact of salary spiking and provide an appropriate base.

Louisiana's exemption from old-age social security coverage for most of its DB plans saves paying 12.4% on payroll, giving it a decided cost advantage over many states. It is also important to note that employee contributions cover a substantial portion of the normal costs of the plans (more than half in LASERS and TRSL).

It is essential that the design of a new system not be attempted by legislative fiat without the assistance of a national pension consulting firm. The system design must take into account a variety of factors including how retirement fits into the overall compensation package and how the creation of the system will affect the funding of the remaining plans. The redesign will have an impact for decades to come and must be well thought out from the start. The consulting firm should be given general guidelines upon which to proceed.

A new Defined Benefit plan should be carefully designed, with the assistance of a national pension consulting firm, to cover future state employees and education personnel. This plan should include:

- **Sub-plan for hazardous duty personnel**
- **Normal retirement age of at least 60, with 10 years service, for full benefits**
- **Average compensation based on 60 highest consecutive months**
- **Automatic COLAs beginning at age 65 pre-funded through employer and employee contributions**
- **Making new plan members ineligible to participate in DROP or to be rehired after retiring**

All new hires should have the option of joining a defined contribution plan with the same normal contribution rates as the basic defined benefit plan. They should be allowed a one-time opportunity to make an actuarially neutral switch to the defined benefit plan after five years of service.

The state should continue to strenuously avoid losing its exemption from participation in the old-age portion of Social Security.

Conclusion

Some have characterized the state's growing public employee retirement obligations as a ticking time bomb that will become an untenable burden for future tax payers. While it is impossible for the $12 billion unfunded liability to come due all at once, the sharply rising cost of paying it down will certainly continue to be a major fiscal burden on the state. Enacting appropriate pension reforms now will not eliminate the burden but could help prevent the situation from worsening and will lower pension costs somewhat over time.

An improved policymaking process would help ensure that future legislation does not purposely or inadvertently increase the state's unfunded obligations. Consolidated administration and centralized investment could produce some cost savings and help unify pension policy. The use of "excess" investment earnings to fund COLAs could be stopped. Efforts could be directed to increasing payments on the UAL; and further increases in the UAL through added unfunded benefits must be avoided.

Finally, a new, cost-effective retirement plan could be designed for future hires that would encourage later retirement and end the need to rehire retirees or provide DROP programs. A proper design could meet employer and employee needs while holding down future costs. An optional DC plan with proper safeguards would offer employees a choice.

There is no practical quick-fix for the poor funding levels of the state pension systems, but pension reforms enacted now can help greatly to bring the situation under control in the future.

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