



STATE LOCAL RETIREMENT SYSTEM



• **NYSAC Policy Brief** •

An Introduction to the New York State and Local Common Retirement Fund and the Employer Contribution Rate Setting Process

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Introduction

New York State Comptroller Thomas DiNapoli recently announced that the New York State and Local Common Retirement Fund had realized a 25.9% return on its investments for the state fiscal year ending March 31, 2010.

With the state, counties and all local governments facing skyrocketing employer contributions rates for public employee pensions in the coming year, a frequently asked question has been: "If Wall Street is doing so well, and the assets of the pension fund are increasing in value, why are public employer contribution rates increasing so significantly?"

This is a legitimate question that can only be completely answered with a full understanding of the operational procedures and investment portfolio of the Common Retirement Fund and how they affect public employer contribution rates in both the short and long term.

This policy brief addresses some of the elements of the Common Retirement Fund, defines some of the terms used and attempts to explain the process the Comptroller uses to set annual employer contribution rates as sole trustee of the fund.

The Common Retirement Fund

The Common Retirement Fund contains two distinct plans: The New York State and Local Employer Retirement System (NYSLERS), which all counties outside the City of New York belong to, and the New York State and Local Police and Fire Retirement System (NYSLPFRS), a system primarily for police officers and firefighters outside of New York City which four counties participate in.

Each of these systems has separate membership categories called tiers, with differing benefit structures and benefit rates. Tiers of membership are basically time periods of enrollments in the pension system with specific benefit rates attached to each time frame. Individuals who enroll in the system during the specified time frames are said to belong to that tier of membership dates. The NYSLERS has 5 membership tiers, and the NYSPFRS has 4 different membership tiers.

There are also numerous optional plans enacted by State legislation that the State and local governments have adopted for special membership categories and employee groups.

Retirement Tiers

The "tier system" of the Retirement Fund came into existence as a means to permit state legislation to reduce the level of benefits available under the retirement system without violating a provision of the New York State Constitution.

Article V, Section 7 of the New York State Constitution states.... "membership in any Pension or Retirement System of the State or of a civil division thereof shall be a contractual relationship, the benefits of which shall not be diminished or impaired."

This provision basically says that the state or local governments cannot take away or lessen the level of pension benefits promised to an individual once they are enrolled in the retirement system. As the state and local governments have experienced financial difficulties in meeting their pension obligations to the Common Retirement Fund over the years, lesser benefit structures have been enacted by the legislature for new incoming employees by creating a new period of enrollment dates, or what has become known as a "tier" to which those benefits structures apply.

Through this process, the state and local governments can reduce the costs of the future pension benefits provided without violating the State Constitution's prohibition from lessening the benefits of existing pension system members.

The recent enactment of a Tier V changed the benefit structure for all new employees hired under NYSLERS after January 1, 2010 by requiring an employee contribution for the life of their membership, for instance, as a way of reducing future state and local government employer contributions rates. Several other changes were also incorporated for new employees that also further reduce the future costs.

The NYSPFRS also had a new Tier V plan adopted which incorporates several different membership

options and enrollment dates. Tier V benefits apply to all of those who join NYSLPFRS on or after January 9, 2010.

According to the Annual Report of the Common Retirement System for the fiscal year ending March 31, 2009, slightly over 5% of the membership of the system are in employee non-contributory Tiers I and II. Almost 95% of the current members of the NYSLERS belong to Tiers III and IV who pay an employee contribution of 3% of salary until they have been a member of the system for 10 years, at which time their employee contributions end.

Individuals hired after January 1 of this year, are all members of the new Tier V in the NYSLERS and will contribute 3% of their salary to the retirement fund for the length of their membership.

All of these tiers have different employer contributions rates, meaning that the size of the county's bill for pension contributions may vary based upon the age and composition of the county's workforce, distribution of their employees among the various pension tiers, and the number of optional plans a county may have chosen to participate in.

Revenue Sources for the Common Retirement Funds

The Common Retirement Fund receives its revenue from 3 different general funding sources: employer contributions, employee contributions and investment earnings of the assets held by the fund. According to the Annual Report of the Common Retirement Fund, over the past 20 years investment earnings on the fund's assets have encompassed 82% of the fund's revenue; employer contributions have provided approximately 14% and employee contributions have amounted to approximately 4% of its incoming revenue received.

Levels of investment earnings of the fund's assets will vary from year to year depending on the make-up of the fund's asset mix and the general economic conditions at the time. Employee contribution levels are affixed by statute but the total amount of revenue received from them can vary from year to year depending on the number of employees reaching the 10 year threshold when contributions cease.

Employer contribution rates are variable and are set based on the amount of money needed to pay all existing benefits over the working life of the membership, minus revenue received from employee contributions and investment earnings. Pension reforms enacted in

2003 established the minimum annual employer contribution rate at 4.5% of salary, although actual annual employer contribution rates have significantly exceeded this minimum level each year since it was enacted.

The Funds Assets

The portfolio of assets held by the Common Retirement Fund, are managed by the State Comptroller as sole trustee of the retirement system. The asset mix is determined by statute and policies established by the State Comptroller and the Retirement System, with 70% of the funds assets held in Equity investments (stocks, real estate, private equities) and 30% held in investments in corporate bonds, mortgages and fixed rate securities such as treasury bills.

The fund attempts to maximize investments, where possible, in businesses and enterprises that have a direct impact on the New York State economy.

A team of professional financial managers oversee and manage the assets of the fund in conjunction with Investment and Real Estate Advisory Boards which assist in establishing the fund's overall investment strategies.

Determining the Value of the Fund's Assets

Like any major private sector insurance, annuity or retirement savings company, the Common Retirement System employs a team of actuaries whose job it is to determine the fund's long term financial needs to meet the benefits promised to system members.

The System's actuarial team also uses the services of an Actuarial Advisory Board, consisting of leading experts in the field who advise the Retirement System on their methods for determining the value of the Funds assets and its future liabilities in terms of benefits payable to system members both in the short and long term.

Each year, the actuaries examine the assets of the fund to determine their value. The actuaries use a method to determine the assets' value which takes into consideration the volatility of the financial and real estate market.

The value of the investments held by the common retirement fund needs to be determined over the long term, rather than on an annual basis alone. A recent event in the stock market where a typographical error resulted in an over 1,000 point drop in the Dow Jones Industrial Average in one afternoon alone, for instance, clearly demonstrated the volatile nature of the stock

market and how it can be drastically affected on a daily basis by external forces.

To protect against significant annual swings in employer contributions rates because of these types of fluctuations in financial markets, the actuaries of the fund average the gains and losses in the value of the assets over a 5 year period, a process called smoothing. Under this method of determining value, the fund does not fully account for major gains or major losses in any one year. What results from their calculations is called the actuarial value of the assets

Since the loss or gain in the value of the assets is smoothed over a 5 year period, a sudden decrease or increase in value does not result in significant spikes or major declines in employer contributions rates in any one year.

The following table illustrates the Common Retirement Fund's Performance over the past 10 year period. The periods of lost value coincide with periods of economic recession in New York State and the United States as a whole.

Fiscal Year Ending 3/31	Rate of Return	Value of Assets (in \$ billions)
2000	17.80%	\$127.1
2001	-8.70%	\$112.4
2002	-2.80%	\$111.2
2003	-10.20%	\$95.6
2004	28.80%	\$119.2
2005	8.50%	\$128.0
2006	14.60%	\$142.6
2007	12.60%	\$156.6
2008	-2.60%	\$155.9
2009	-26.40%	\$110.9
2010	25.90%	\$132.6

The actuarial value of the Fund's assets declined by \$45 billion in fiscal year 2009, during the peak months of our current national economic recession. The \$21.7

billion increase in value realized in 2010 restores less than half of the amount lost in 2009 leaving over \$23 billion dollars in value needed to return to the Fund's 2007/2008 levels.

Determining the Employer Contribution Rate

In April of each year, the actuaries determine how much money is required to pay all current and future benefits to members and retirees of the system. These are called the Fund's actuarial liabilities. To arrive at this projection of benefit liabilities, the actuary will examine the current make-up and benefits due to every member, retiree and beneficiary in the system.

They will also project future earnings and service credit growth, estimate the probable retirements, disabilities and withdrawals from the system that will occur, factor in future cost-of-living adjustments payable to retirees and the life expectancies of members and their beneficiaries. These indicators are all developed based on past history of retirement system members often referred to as experience.

When the future benefit liabilities are determined, they are adjusted to determine how much money needs to be in the fund today, to pay all future benefits taking into consideration an expected growth in the systems assets value of 8% annually and the funds experience rate for member and beneficiary mortality. This calculation determines what is called the present value of benefits.

The present value of benefits is then compared to the actuarial value of the fund's assets that includes investments and employee contributions. The difference in these two numbers is made up through employer contributions. That difference is spread out over the expected working lives of the existing members (as determined by the actuaries) and a rate of employer contribution is determined for each tier and optional plan since each offer different levels of benefits.

The retirement system has determined what is called a Long Term Expected Rate for each tier and optional plan for employer contributions which is a percentage that can be expected to be paid by employers every year to pay all of the benefits to members when they are needed, assuming that the value of the assets goes up 8% each year.

The Long Term Expected Rate for those employees enrolled under Tier IV, the tier most NYSLERS members are enrolled in, is 11.0% of salary. Generally speak-

ing, employer contributions rates in excess of 11.0% occur when the systems assets do not attain a return of at least 8% and rates below 11.0% occur when the value of assets of the fund return more than 8%.

Why Did this Year's Employer Contribution Rate Jump From 7.4% to 11.9%?

Reforms to the Common Retirement Fund enacted in 2003 as a result of employer pensions contributions spikes that followed a major benefit enhancement enacted by the State and an economic recession brought on by the September 11th terrorist attacks, established a new billing method for employer contribution rates.

In prior years, the employer contribution rate and billing was determined by the Common Retirement System and sent to counties in November for payment by the following February, oftentimes after county budgets had already been adopted. The unforeseen sudden increase in employer contribution rates that occurred following the September 11th attacks lead the State Comptroller to submit legislation that adjusted the schedule for employer billing and payments.

The reforms enacted provided the state and local governments with almost a year to plan and budget for the implementation of higher contributions rates that might result because of economic downturn and a loss in value of the Funds assets.

The 2011 NYSLERS Employer Contribution Rate of 11.9% and NYSLPFRS Contribution rate of 18.2% are based upon the Common Retirement Fund's Performance between 2005 and 2009 because of the 5 year smoothing methodology used by the fund.

The increased employer contribution rate for the 2011 billing is based upon the significant downturn of the assets of the fund over the last 2 fiscal years (2008, 2009) when the funds' assets declined in value by -2.6% and -28.6% respectively during the height of the national economic recession. These downturns were only slightly offset by better fund performance in 2005-2007.

The fund's increase in value of 25.9% for this past fiscal year as recently announced by the State Comptroller will not be factored into the employer contribution rate computation until next year's billing cycle. This major increase in value will only slightly offset the declines experienced in 2008 and 2009 which will continue to be factored in due to the Retirement Systems' 5 year smoothing methodology.

Despite the major increase in performance of the system's assets of 25.9% in the last fiscal year ending March 31, 2010 to an estimated \$132 billion, the overall value of the assets of the Common Retirement Fund is still over \$23 billion less than it was at the early stages of the recession in March of 2008 when they were valued at \$155.9 billion.

What Does the Future Hold?

According to the Office of the State Comptroller the increase in the average rate under NYSLERS from 7.4% to 11.9% will result in a contribution increase to all employers of the system of approximately \$1.2 Billion. This increased contribution level amounts to about 5% of the \$23 billion needed to restore the value of the assets to its 2008 level of \$155.9 Billion.

Despite recent improved performance of the Funds' investment portfolio, these gains are insufficient to substantially reduce employer contribution rates. In the absence of further significant market gains like those experienced in the past year, employer contribution rates will continue to increase for the foreseeable future.

Enactment of the new Tier V pension tier will reduce the Long Term Expected Contribution Rate for new employees from the current 11.0% for Tier 3 & 4 employees, to 8.8% for those new employees enrolling under Tier V after January 1, 2010.

This new tier will help lower costs to local governments and the state in the future, but will not have a significant impact on employer contribution rates in the short term. Sustained economic recovery and the resulting increase in the value of the system's assets over the long term are necessary if counties and all local governments are to experience a decrease in future employer contribution rates.

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