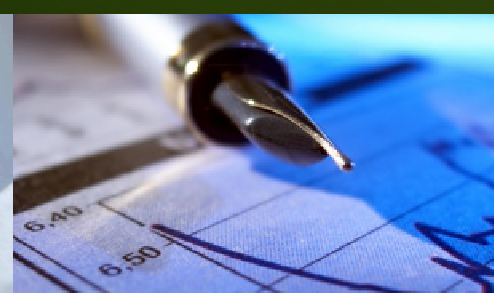
Accounting for Law Enforcement/ Custodial Officer Retirement Costs

January 2015



Senate Bill 1459, Section 30 from the 83rd Legislature requires ERS to separately account for the retirement assets and liabilities associated with the Law Enforcement and Custodial Officers (LECO) member population.

ERS
Employees Retirement System of Texas

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ACCOUNTING FOR LAW ENFORCEMENT/ CUSTODIAL OFFICER RETIREMENT COSTS

Based on the August 31, 2014 Actuarial Valuations

Law Enforcement and Custodial Officers (LECO) have higher cost benefits that increase funding requirements for the state's retirement plans.

Traditional defined benefit retirement plans, such as the ones administered by ERS, are based on years of service, final average salary, and a benefit multiplier. LECO employees and Regular Class state employees both receive annuities from the ERS Retirement Trust Fund, based on a 2.3% benefit multiplier per year of service.

In addition, LECO employees receive supplemental retirement benefits from a separate trust called the Law Enforcement and Custodial Officers Supplemental Retirement Fund (LECOSRF), which provides an additional 0.5% benefit multiplier. However, the ERS Retirement Trust pays most of the LECO employees' retirement benefit – approximately 80%.

LECO benefits cost more than those provided to Regular Class state employees because law enforcement and custodial officers can retire younger with fewer years of service. Despite the differences in costs, the two groups contribute the same amount to the ERS main plan, 6.9% for fiscal year 2015. The state has also historically contributed the same amount for both groups to the ERS main plan, 7.5% for fiscal year 2015. LECO employees began contributing an additional 0.5% of payroll in fiscal year 2010 to the LECOSRF trust fund.

In general, LECO employees receive a more expensive retirement benefit than Regular Class employees including:

- Eligibility to retire at an earlier age with a full, unreduced annuity from both the ERS main fund and LECOSRF;
- An annuity from the main ERS fund that is about 10% more valuable than what Regular Class employees receive; and
- A combined main fund and supplemental annuity that is about 25% more valuable.

Demographic trends among the two retiree and employee populations also highlight this benefit trend. As shown in the graphic below, LECO members retire from the state at a younger age than Regular Class state employees, with fewer years of service, and a more generous benefit. Among current employees, LECO employees on average are younger, have fewer years of service and make a lower salary than Regular Class state employees.

Profile of Average Regular Class and LECO Retirees/Members*

As of August 31, 2014

Average Regular Class Retiree	
Years of Service	22.6
Age at Retirement	59.0
Age in 2014	69.2
Total Expected Years Receiving Annuity	27.1
Average Annuity	$19,030

Average Regular Class Employee	
Years of Service	9.6
Age	45.0
Average Annual Salary	$45,440

Average LECO Retiree**	
Years of Service	21.4
Age at Retirement	55.5
Age in 2014	63.4
Total Expected Years Receiving Annuity	29.7
Average Annuity	$23,048

Average LECO Employee	
Years of Service	8.9
Age	42.3
Average Annual Salary	$41,584

*Statistics shown for Regular Class retirees and employees are separate and distinct from statistics shown for LECO retirees and employees.

**Annuitants with at least 10 years of Certified Peace Officer (CPO)/Custodial Officer (CO) service are identified as LECO annuitants. There are some annuitants who earned service as a CPO/CO who did not work long enough (20 years) to be eligible for a LECOSRF annuity, but do receive an ERS annuity.

Source: Gabriel Roeder Smith.

By the Numbers - Separating LECO Costs

So how do the liabilities, assets and cost rates differ when LECO and Regular Class state employees are accounted for separately? The following table shows the differences between the two populations.

Summary Comparison of Assets and Liabilities Accounting by Employee Population

As of August 31, 2014

	Regular Class State Employees	Law Enforcement and Custodial Officers (LECO)
Membership		
Number of:		
Active members	97,078	37,084
Retirees and beneficiaries*	79,640	16,200
Inactive members, Vested	14,239	2,500
Inactive members, Non-vested	62,058	17,710
Total Membership	253,015	73,494
Valuation Payroll (billions)	$4.6	$1.6
Contribution Rates (Fiscal Year 2015)		
Member**	6.90%	7.40%
Agency	0.50%	0.50%
State***	7.50%	9.20%
Total Contribution Rate	14.90%	17.10%
Actuarially Sound Contribution Rate (%)	18.12%	23.51%
Contribution Rate Shortfall	(3.22%)	(6.41%)
Assets		
Market Value (billions)	$20.4	$5.5
Actuarial Value (billions)	$20.7	$5.6
Return on market value	14.7%	14.7%
Return on actuarial value	7.6%	7.6%
Actuarial Information		
Normal Cost Rate (%)	11.30%	14.12%
Actuarially Accrued Liability (billions)	$26.0	$8.1
Unfunded Actuarially Accrued Liability (billions)	$5.3	$2.6
Funded Ratio (%)	79.8%	68.6%
Funding Period	Never	Never

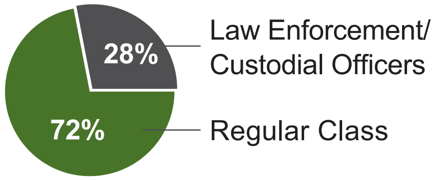
*Annuitants with at least 10 years of Certified Peace Officer (CPO)/Custodial Officer (CO) service are identified as LECO annuitants. There are some annuitants who earned service as a CPO/CO who did not work long enough (20 years) to be eligible for a LECOSRF annuity, but do receive an ERS annuity.

**The LECO member contribution of 7.40% represents a 6.90% contribution to the ERS trust and a 0.50% contribution to the LECOSRF trust.

***The LECO state contribution of 9.20% represents a 7.50% contribution to the ERS trust, a 0.50% contribution to the LECOSRF trust and an estimated 1.20% contribution from dedicated criminal court cost revenue that is deposited to the LECOSRF trust.

Source: Gabriel Roeder Smith.

ERS Plan Active Members*



*Current state employees contributing to the plan.

LECO members represent 28% of the total ERS/LECOSRF active membership. The normal cost (the benefit cost accrued each year as a percent of payroll) for LECO employees is 2.82% higher than Regular Class state employees. The total contributions received by the trusts ideally would be at least that amount higher for LECO employees to provide for the higher cost of their benefit accruals. When the impact of existing unfunded liabilities is factored into the contribution rates, LECO employees require a total contribution of 23.51% to be actuarially sound, 5.39% higher than Regular Class state employees.

If the state were to set separate contribution rates for each population based on their costs and the current contribution rates of 7.5% for the state and 0.5% for the agency, Regular Class state employees would need to contribute 10.12% of salary and LECO employees would have to contribute 15.51% of salary to reach the actuarially sound contribution rate. This level of contribution increase may not be practical for either employee population. However, if paired with contribution increases from the state, a gradual increase in the member contributions for both populations may be feasible.

Separately accounting for LECO and Regular Class members does not lower existing liabilities; it allocates costs more appropriately to each group. Both the ERS and LECOSRF plans have been chronically underfunded. From fiscal years 1996 to 2015, ERS did not receive the full contribution needed in 19 out of 20 years. The Legislature took a contribution holiday in LECOSRF from fiscal years 1994 through 2007. Since LECOSRF contributions resumed in fiscal year 2008, the state has increased the overall contribution rates but the contributions are below needed funding levels. In addition, member contributions of 0.5% to the LECOSRF trust did not begin until fiscal year 2010. Accounting for LECO and Regular Class members separately highlights that as a percent of payroll, the underfunding has been more pronounced for LECO member benefits.

Separate Accounting and Set Population-based Contribution Rates

To make benefit costs more transparent for each employee population, there are a couple of options the Legislature could pursue.

OPTION 1: Combine the ERS and LECOSRF trusts into one trust. Set different contribution rates for Regular Class employees and LECO employees relative to the benefit cost for each population, but deposit the contributions and pay benefits from one trust fund.

There are two advantages to this option. First, the current plan determination letter from the Internal Revenue Service (IRS) – which verifies that the plans are in good standing with the IRS - would allow for the trusts to be combined without requiring a new determination. Second, it may be administratively easier for the agency to manage the plans from one trust, especially since many LECO employees will have some amount of non-LECO state service.

Action Steps for Option 1:

- Legislative action to amend statute to blend the trusts and set separate contribution rates.
- Agency action to set new ERS administrative rules, as needed.

OPTION 2: Separate LECO-employee related assets and liabilities from the ERS trust and blend them into the LECOSRF trust to create two stand-alone plans, one for Regular Class state employees and one for LECO employees.

The advantage to this option is that it may be easier for employees and policymakers to understand how the plan works. However, this change would be more complex for the agency to administer due to increased member communication needs and a doubling of monitoring activities. In addition, separating the plans into separate trusts will require IRS approval for tax qualification purposes.

Action Steps for Option 2:

- Legislative action to amend statute to separate trusts and set separate contribution rates.
- Agency action to set new administrative rules, as needed.
- Agency action to apply to IRS for plan determination.

How Other States Handle LECO Benefits

Other states structure their retirement benefits for state law enforcement and custodial officers in a variety of ways. Benefit structures include being part of one plan with enhanced benefits, being part of a separate plan, or both. According to the National Conference of State Legislatures (NCSL), the only generalization for public safety employees consistent across states is that there are different plan provisions for this population compared to general state employees or teachers.

NSCL also notes that, in general, public safety employees:

- Can retire earlier than other employees;
- Are less likely to be covered by Social Security (this does not apply to ERS/LECO);
- Have higher levels of their salary replaced by retirement benefits compared to other employees; and
- Contribute a higher percentage of their pay toward their retirement benefits than other employees (0.6% higher among plans where members are part of Social Security).