MEMORANDUM

JOINT BUDGET COMMITTEE

TO	PENSION REVIEW SUBCOMMITTEE
FROM	Alfredo Kemm, JBC Staff (303.866.4549)
DATE	September 3, 2019
SUBJECT	AED and SAED

Prefatory note: Discussion of AED, SAED, and other PERA-related rates and figures in this document are related to the experience of state employees as a function of the statewide compensation system. Pension principles may be extended to employees located in other PERA Divisions and pension experience generally. However, the rates and figures presented here represent either state employees in the appropriated state budget or the State Division of PERA.

EXECUTIVE SUMMARY

By statute, employers make an additional amortization payment for PERA's unfunded liability known as the Amortization Equalization Disbursement or AED and Supplemental Amortization Equalization Disbursement or SAED. Generally, AED and SAED are calculated and paid at 5.0 percent each on current payroll.

The policy argument for increasing employee contribution rates or paying for the unfunded liability through the current payroll system is the "shared" or "pooled" basis of a pension. "We're all in this together." This is the idea that a pension is a joint pool of funding in which there is no way to discretely subdivide the amorphous asset pool by member.[1] When pooled with employees from preceding PERA-benefits-structure-generations, current employees share in the cost of the unfunded liability.

However, normal cost or the normal cost rate is the actuarially determined cost for retirement benefits earned in a year. Normal cost is between 8.82 percent and 12.11 percent for current employees. The current year employee contribution is 8.75 percent and the employer contribution is 10.4 percent, totaling 19.15 percent. At a normal cost rate of 8.82 percent, employees almost fully fund their own benefits costs in FY 2019-20. At a normal cost rate of 12.11 percent, current employees are "overfunded" by 7.04 percent from the total employee-employer standard contribution rate. Staff estimates that the total PERA contribution rate on salary for FY 2020-21 will be 33.4 percent. Current employees will be "overfunded" by 21.29 percent from all PERA payroll-related contributions. The "overfunded" portion pays for the unfunded liability. AED and SAED policy suggest that retirement cost for current employees may be as high as 33.4 percent. The math of normal cost establishes the fact that current employees do not contribute to the unfunded liability and improve the funded status.

AED and SAED are located in the compensation common policy section of each department's budget. However, AED and SAED are not benefits paid to or received by current employees. AED and SAED are strictly payments to reduce PERA's unfunded liability. Cash and federal sources which pay current payroll costs, also pay for AED, SAED, and other payroll-related contributions. Cash and federal sources will provide $113.4 million as appropriated in the FY 2019-20 budget. This amount would otherwise have to be paid from General Fund to effect a more transparent payment policy.

[1] Although amorphous in joint liability, it is nevertheless possible to create and discern discrete differences in contribution and distribution structures based on when an employee began employment and PERA membership.

AMORTIZATION PAYMENTS TO IMPROVE PERA'S FUNDED STATUS

Actuarial analysis of the Public Employee's Retirement Association (PERA) showed that PERA's increasing unfunded liability or, alternatively, decreasing funded status, led the legislature to pass bills in 2004 and 2006 increasing contributions to the pension plan above the base employer and employee contribution rates. These additional contributions are called the Amortization Equalization Disbursement (AED) and Supplemental Amortization Equalization Disbursement (SAED). Pursuant to Section 24-51-411, C.R.S., the State contributes additional funds to assist in the amortization of PERA's unfunded liability.

An amortization payment, much as a mortgage payment, generally represents a standard payment made in installments over a period of time. However, similar to a graduated mortgage payment, the AED and SAED amortization plans were structured as negative amortizations. Amortization means reduction in the payoff balance – the amount still owed. The first feature of a negative amortization reflects a payment plan in which initial payments are less than the interest owed. The unpaid interest is added to the principal balance, causing the payoff balance to increase for a period. The second feature of a negative amortization reflects a payment plan in which payments increase over time. As payments increase, eventually the interest payment is made in full, and there is no further increase in principal balance due to the capitalization of unpaid interest. As payments continue to increase over time, the share paid to the principal balance accelerates and interest payments decrease.

Negative amortizations are characterized negatively relative to a standard amortization payment primarily due to the higher payment made over the life of the plan. However, the negative amortization payment plan served to provide the following political and strategic advantages:

- The payment plan was structured as a complicated mechanism on payroll, rather than as a standard dollar amount payment to be made by each employer. The statutory or policy complication makes it more difficult to both comprehend as policy (it is essentially a debt payment and not a current employee benefit). It is therefore more challenging to amend or repeal in statute as compared to a simple, direct payment structure.

- The payroll-based structure enabled the payments to appear as a cost for current employees rather than as a debt payment for legacy costs. The policy mechanism enables the deflection of blame from a class responsible for the liability – past policy decision makers – to a class assigned to "pay" for the liability – current employees.

- The payroll-based structure enabled the payments to be borne by all payroll fund sources (cash and federal funds) and not simply state funds (General Fund).

- The negative amortization plan served the "political will" as a gentle, "ramped" approach to pay the unfunded liability gradually. This allowed the state budget, and other employer budgets, to adjust over time to an increasing payment regimen.

As state payroll increases, the AED and SAED payments, calculated on payroll, increase over time. AED and SAED rates increased gradually at 0.4 and 0.5 percent annual increments, respectively, until reaching a maximum of 5.0 percent. Both characteristics contribute to the "increasing payment" component of the negative amortization plan.

The AED rate (except for judges) increased 0.4 percent each calendar year until reaching the maximum contribution rate of 5.0 percent for calendar year 2017. The SAED rate (except for judges) increased 0.5 percent each calendar year until reaching the maximum contribution rate of 5.0 percent for calendar year 2017. The AED rate for judges remained constant at 2.2 percent for AED and 1.5 percent for SAED. House Bill 17-1265 (*PERA Judicial Division Total Employer Contribution*) enacted AED increases to 3.4, 3.8, 4.2, 4.6 and 5.0 percent and SAED increases to 3.4, 3.8, 4.2, 4.6, and 5.0 percent in each succeeding year beginning in calendar year 2019.

SAED ATTRIBUTION

Both the AED and SAED are payments made by the employer. However, although the SAED payment is made by the State, statute specifies that funding is to come from money that would have otherwise been paid to state employees for salary increases, pursuant to Section 24-51-411 (10), C.R.S. If payments made for SAED were instead paid as salary increases, this amount would appear as an increase of five percent in the salary base and directly increase each state employee's salary by five percent.

The State's contribution to PERA has often been cited as 20 percent, including the 10.4 percent standard employer contribution plus 5 percent each for AED and SAED. However, it is also reasonable to cite – and perhaps more accurate by law – to attribute a contribution rate of 15.4 percent from the State and 13.75 percent from employees.

NORMAL COST

Normal cost or the normal cost rate is the actuarially calculated cost for retirement benefits earned in a year and is calculated as a percentage of salary. The normal cost rate for employees in the State Division for calendar year 2019, as identified in the Cavanaugh Macdonald actuarial valuation report for calendar year 2017, was 10.32 percent. The normal cost rate for employees in the State Division for calendar year 2020, as identified in the Segal actuarial valuation report for calendar year 2018, is 12.11 percent. Staff has requested an explanation from PERA for this 17.3 percent increase in normal cost rate over one year.

Senate Bill 18-200 reduced the benefits structure for future member retirement benefits. The statewide employee workforce includes a spectrum of PERA members that include those retiring today to those starting employment today. A reduced benefits structure policy has the effect of reducing the average normal cost over time as new employees enter state employment with a leaner benefits structure and existing employees exit or retire with a richer benefits structure. If benefits structure effects from S.B. 18-200 are not yet affecting normal cost, a similar effect should be ongoing from the changes in S.B. 10-001.

The June 2015 alternative plan design cost and effectiveness study completed by Gabriel, Roeder, Smith for the Office of the State Auditor identified a normal cost rate of 8.82 percent at that time for new hires, defined as hired on or after January 1, 2011 (post-S.B. 10-001). As existing employees retire leaving only members hired after 2011, the normal cost rate would decrease over time until reaching approximately 8.82 percent. New hires based on changes made in S.B. 18-200 will continue to decrease the normal cost to a rate that approaches the normal cost for new hires under the newest benefits structure.

STANDARD EMPLOYEE CONTRIBUTION RATE AND STATE SHARE OF NORMAL COST

Based on increases included in S.B. 18-200, the standard employee contribution rate increased to 8.75 percent in FY 2019-20, and increases to 9.5 percent in FY 2020-21 and to 10.0 percent in FY 2021-22. Additionally, the automatic increase provisions included in S.B. 18-200 will be triggered for FY 2020-21, necessitating a further 0.5 percent increase in employee contributions for that year and future years. Thus, the standard employee contribution rate will increase to 10.0 percent in FY 2020-21, and to at least 10.5 percent in FY 2021-22.

At the most recently identified 12.11 percent normal cost, the employee standard contribution rate of 10.0 percent in FY 2020-21 leaves 2.11 percent for the state contribution rate to cover to fully pay for the normal cost. At the prior year's identified normal cost rate of 10.32 percent, employees would cover all but 0.32 percent of the normal cost. At the Gabriel, Roeder, Smith study's identified 8.82 percent normal cost for employees hired since 2011, employees will entirely cover their normal cost and pay 1.18 percent of their current income for the unfunded liability.

Current employee retirement costs are fully paid in the normal cost. Current employee retirement costs do not contribute to the unfunded liability. Including SAED, current employees could be considered to be contributing 15.0 percent of salary to cover their retirement benefit cost of 8.82 to 12.11 percent in FY 2020-21. Effectively, and functionally, this has the effect of both an inter-generational transfer of income from current and future employees to past employees and may function as an income or payroll tax on current and future employees to pay for a state-incurred liability.

THE UNFUNDED LIABILITY

The unfunded liability problem is not a problem caused or generated by current budget year employees. In fact, current and future employees help to pay for the unfunded liability in the standard employer-employee contribution rates, not including additional payroll-related amortization payments.

While it is regularly pursued as a method of governing, it is reflective of neither transparent budgeting nor good government principles to find select groups or classes to pay for the State's responsibilities as a result of past poor sustainability planning and decision making. As a matter of public policy fairness, additional policy changes to address the unfunded liability should not be addressed through additional contributions, "participation payments", or taxes from current and future employees.

Routing amortization payments through current employee contributions and through employer contributions tied to payroll, creates a policy distortion and fiscal sleight-of-hand that makes it appear as if current employee retirement costs are at least 28 percent and rising.

THE PROBLEM WITH AED AND SAED

JBC staff has communicated transparency concerns with the AED and SAED mechanisms for several years in staff documents. What began as a minimal increased contribution for the purpose of making additional amortization payments in 2004, following the economic downturn of 2001, was doubled in 2006 with the SAED policy.

The PERA "direct distribution" in S.B. 18-200 was initially intended as a state-funded direct payment for the unfunded liability. The direct distribution was not constructed in statute as a payroll calculation

or mechanism. Nevertheless, in order to collect payments from cash and federal fund sources, in last year's budget the "direct distribution" for PERA was allocated as a compensation common policy budget item for the state employee portion of $56.5 million in a manner that aligns with AED and SAED allocations by state agency. Staff estimates that the payment represents an additional 3.0 percent contribution when calculated on payroll.

In total for FY 2019-20, amortization-related payments total 13.0 percent of payroll in addition to the 10.4 percent standard employer contribution. It is staff's understanding that the federal government allowed for up to 23.28 percent for pension-related payroll contributions from federal sources for FY 2016-17. Not constructed in statute as a payroll calculation, it is not clear that the direct distribution allocation will be collected from federal fund sources for FY 2019-20 even if the federal government allows a payroll-related contribution as high as 23.4 percent.

The AED as originally intended may have been a reasonable policy response to a relatively small, unfunded liability problem. The AED and SAED superstructure of today has very little transparency as to its purpose. The payroll-based allocation superstructure makes it appear as if current employee retirement costs are equal to approximately 33.4 percent of salary when including the 10.4 percent employer contribution rate, the 10.0 percent employee contribution rate (FY 2020-21), the 5.0 percent AED and 5.0 percent SAED, and the approximately 3.0 percent from the direct distribution.

To the average observer – citizen or legislator – it is hard to discern that the AED and SAED and the PERA direct distribution allocation in every department budget are not payments made for current employee compensation. While not apparent by the budget, these are entirely and exclusively state debt payments for past service commitments. These payments, however, are routed through and located in the payroll process and compensation budget structure.

Fundamentally, and for increased budget transparency, standard contribution rates should more closely reflect the structural cost of benefits – the annual, normal cost. The difficulty in reforming to a more transparent contribution rate and additional amortization payment system is the loss of payment from cash and federal sources gained through payroll process. Total appropriations for AED, SAED, and the direct distribution totaled $244.4 million in FY 2019-20. Of that, General Fund paid $131.0 million or 53.6 percent and cash and federal funds paid $113.4 million or 46.4 percent.

STATE BUDGET

Mechanically, in the budget, AED and SAED appropriations are calculated on revised base salary, which includes base salary, salary survey, merit pay, and shift differential; essentially, maximum gross payroll. In practice, in payroll and accounting records, AED and SAED are calculated for each individual employee, and also take into account any deductions from gross pay prior to PERA calculations; essentially, net pay by employee summed across all state employees.

AED and SAED budgeted appropriations are calculated to pay for all current and anticipated FTE in a fiscal year. However, net pay calculations at the individual employee level will necessarily reduce the amount actually paid to PERA for AED and SAED for state employees relative to the appropriated amount, due to: employee café plan deductions; leave without pay situations; less than full-year positions due to turnover and delays in filling positions; and related adjustments in actual payroll,. This payment system is not as effective at paying an anticipated amount as compared to a direct payment in which a payment is budgeted and fully paid. In a direct payment system, dollars set aside in the state

budget would neither revert nor be channeled to other payroll components, including base salary, at the accounting record level.

AED and SAED are commonly considered to be part of the total compensation package because payment amounts are calculated on total salary. While AED and SAED represent a cost to the State and are paid by state agencies on total payroll, they are neither technically nor actually paid to state employees as compensation. Therefore, when discussing statewide employee compensation, it is reasonable to exclude AED and SAED when estimating the increase in total compensation funding to be paid to state employees.

The following table outlines the most recent 10-year history of AED and SAED appropriations.

PERA Amortization Payments (AED/SAED) 10-year Appropriations History (in millions)										
	FY10-11	FY11-12	FY12-13	FY13-14	FY14-15	FY15-16	FY16-17	FY17-18	FY18-19	FY19-20
AED Total Approps.	$33.3	$40.3	$44.6	$52.5	$62.1	$70.1	$78.3	$84.8	$89.8	$94.0
SAED Total Approps.	23.2	32.8	38.0	47.1	58.0	67.3	77.0	84.4	89.6	93.9
PERA Amortization Payments	$56.5	$73.1	$82.6	$99.6	$120.1	$137.4	$155.3	$169.2	$179.4	$187.9
Change		16.6	9.5	17.0	20.5	17.3	17.9	13.9	10.2	8.5
Percentage Change		29.4%	13.0%	20.6%	20.6%	14.4%	13.0%	9.0%	6.0%	4.7%
9-year total percentage change										182.3%
Compound average annual growth rate										12.8%