How much does the Tier 6 proposal reduce employee retirement benefits?

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Governor Cuomo's proposed Tier 6 pension reform has many far-reaching elements, including reducing the annual benefit multiplier, increasing employee contributions, raising the retirement age, reducing the calculation for the final average salary (FAS), providing a defined contribution option, and reducing the employer pension contribution for SUNY and CUNY faculty and staff. Changes are also made regarding overtime pay and unused sick leave, among other changes. The purpose of this brief is to quantify the value of the reduction in retirement benefits to the typical member of the NYS Employees' Retirement System (ERS) under the Tier 6 proposal.

The three provisions that would affect the value of the pension benefit for all future ERS retirees under Tier 6 are:

1) The reduction in the annual benefit multiplier from 2.0 percent to 1.67 percent;
2) The increase in the retirement age to 65 from 62 (there is no provision for receiving a reduced benefit for early retirement before age 65); and
3) Increasing the number of years that enter into the determination of the final average salary (FAS) from the three highest consecutive years to the five highest consecutive years, and reducing the limit on the extent by which any one such year might exceed the average of the previous four years.

Reducing the annual benefit multiplier

The amount of a retiree's annual pension is determined by multiplying the benefit multiplier by the number of years of service by the FAS. The reduction in the benefit multiplier from 2.0 to 1.67 percent is a 16.67 percent reduction in the annual pension amount. Under the Tier 5 plan that took effect on January 1, 2010, a 30-year employee receives 60 percent of their FAS. Under Tier 6, that employee receives 50 percent.

Raising the retirement age

When it comes to valuing pension benefits, age is a decisive variable for both employers and employees. Everything else being equal, a 65-year old is not going to live as many more years as a 62-year old. Actuaries translate that fact into a present value savings for an employer, and a present value loss for a prospective retiree. How much difference does three years make to a prospective retiree? Under Social Security, for example, you can retire at 62 but you would receive a smaller monthly benefit. For those born after 1959, full retirement age under Social Security is 67 years. Someone who retires at age 64, three years before full retirement, would receive a monthly Social Security benefit 20 percent smaller than someone who retires at 67. That works out to 5/9 of one percent per month (5/9 x 36 months = 20 percent.)[1]

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[1] See http://www.ssa.gov/retire2/retirechart.htm#chart.

For a prospective retiree, raising the retirement age from 62 to 65 under New York's public employee pension system for a given annual amount of benefit means a 20 percent reduction in the lifetime value of that pension.

Increasing the years that enter into determining FAS, and limiting increases

In making calculations of the employer contributions under different pension plans, the actuary for the New York State and Local Employees' Retirement System (ERS), Michael Dutcher, assumes that the salaries for ERS-covered employees increase an average of 5.4 percent a year.[2] This estimate reflects several factors that affect wage levels, including inflation, productivity, merit, promotions, across-the-board negotiated wage increases, and step increases. Lengthening the period of time used to calculate the final average salary (FAS) obviously reduces the FAS—the average of the three highest consecutive years will always be greater than the average of the five highest consecutive years.[3]

The Tier 6 proposal includes another change that affects the FAS, by excluding from the FAS calculation for the highest five consecutive years any increase that exceeds the average of the previous four years by more than 8 percent. The "circuit breaker" threshold is 10 percent in Tiers 3, 4 and 5.

The Appendix shows the calculations for the impact of these two changes in the FAS, and the overall impact of the 3 factors (benefit multiplier, increased retirement age and changes in FAS calculation) in reducing the value of the pension benefit under the Tier 6 proposal.

Summary

Thus, under the proposed Tier 6 pension, as the calculation in the Appendix shows, the typical ERS-covered employee would receive a pension with a value that is 39.8 percent lower than currently provided under Tier 5.

In his fiscal note on the Tier 6 proposal, the ERS actuary determined that the annual long term expected employer contribution would be 4.7 percent. Under Tier 5, the long term employer contribution is 9.4 percent.

In summary, according to the actuary, the Tier 6 proposal reduces the employer contribution by 50 percent, and by the calculations presented here, it reduces the employee benefit by 39.8 percent. Presumably, the difference between these two figures is accounted for by other reductions included in the Tier 6 proposal, including the increased employee contribution; the exclusion of overtime; the elimination of service credit for unused sick leave; and the lengthening of the minimum vesting period from 10 to 12 years.

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[2] See the Actuarial Funding and Valuation section of the ERS annual report, http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_11.pdf, p. 105.

[3] The values would be equal only when an employee's salary was flat for five consecutive years.

Appendix

Tier 6's two changes in the calculation of the FAS, together with changes in the benefit multiplier and retirement age, sharply reduce the value of an employee's pension benefit.

1. For purposes of determining the impact of the two changes in the calculation of the FAS, an employee's salary needs to be simulated for nine years due to the maner in which the 8% limit is calculated. These years do not necessarily have to be the nine years prior to retirement, but for most employees the final nine years will be the years with the highest earnings.

		Tier 5		Tier 6	
	Assume $40,000 salary for employee 9 years from retirement *	10% limit on avg. earnings of previous two years	Salaries that enter into FAS calculation	8% limit on avg. earnings of previous four years	Salaries that enter into FAS calculation
Retirement minus 9 years	$40,000				
Retirement minus 8 years	$42,160				
Retirement minus 7 years	$44,437				
Retirement minus 6 years	$46,836				
Retirement minus 5 years	$49,365			$46,827	$46,827
Retirement minus 4 years	$52,031			$49,356	$49,356
Retirement minus 3 years	$54,841	$55,768	$54,841	$52,021	$52,021
Retirement minus 2 years	$57,802	$58,780	$57,802	$54,830	$54,830
Retirement minus 1 year	$60,924	$61,954	$60,924	$57,791	$57,791

FAS calculation under Tier 5	FAS calculation under Tier 6
Average of highest 3 consecutive years, subject to 10% limit	Average of highest 5 consecutive years, subject to 8% limit
$57,855	**$52,165**

Impact of change in FAS calculation = (52,165/57,855) = 0.9016

2. Calculating the overall reduction in annual pension benefit due to Tier 6 changes: = 1 - (impact of reducing annual benefit multiplier) x (impact of raising retirement from 62 to 65) x (impact of change in FAS calculation)

Overall reduction due to Tier 6 changes = 1-(1.67/2) x (0.8) x (52,165/57,855) = 0.3977 39.8%

* Actuary assumes a 5.4% average annual salary increase. See the text and the ERS annual report, http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_11.pdf, p. 105.

This calculation of the reduction in annual pension benefit due to Tier 6 does not reflect the exclusion of overtime, or any of the other proposed changes.

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