New York City Independent Budget Office

Focus On:
The Preliminary Budget

March 2020

Change in Calculation of Education Retirement Benefit Will Save $125 Million Annually

The Mayor's Preliminary 2021 Budget and Financial Plan for 2022-2024 includes a $125 million reduction to the city's projected pension costs in each year. This reduction is a result of a change in the way the city's pension plans account for the pensions' assets contributed through Tax Deferred Annuity (TDA) plans.

Members of the Teachers Retirement System (TRS) and the Board of Education Retirement System (BERS) have the option to contribute to a Tax Deferred Annuity. TDA is the umbrella term for a set of section 403(b) deferred compensation plans that offer members an additional voluntary retirement plan to supplement their pension earnings. The majority of the plans function like typical defined contribution retirement plans—members are presented with a menu of investment strategies in which returns are subject to the fluctuations of the market. Alternatively, members can invest in a Fixed Return Fund that guarantees an interest rate of either 7.0 percent or 8.25 percent, depending on the member's civil service title. Currently 71.8 percent of TDA funds ($27.4 billion of $38.1 billion) for TRS and BERS members are invested in the Fixed Return Funds.

Dollars in the Fixed Return Funds are co-invested with the assets of their respective pension funds. This is in contrast to the variable TDA options, which are invested separately and have no guaranteed returns. Essentially, the members investing in the Fixed Return Funds are providing the pension plans with a loan that provides the investor a guaranteed interest rate. As with any loan, the pension funds as borrowers are responsible for paying the interest due on the Fixed Return Funds, which is paid at the conclusion of each year. Accounting for the share of members who receive either 7.0 percent or 8.25 percent interest, the average or blended interest rate due on the Teachers Retirement System's Fixed Return Fund TDAs is 7.2 percent, while the blended interest due on the Board of Education's Fixed Return Fund TDAs is 7.9 percent; the average rate received by TRS participants is lower because 80.5 percent of TRS plan participants are in the 7.0 percent fund, compared with only 21.3 percent of BERS plan participants.

In years where the pension systems exceed the blended interest rate due to the Fixed Return Funds, the excess returns represent net gains to the pension systems, as all returns in excess of the plans' Fixed Return Fund blended interest rate remain with the pension assets. In years where returns fail to reach the Fixed Return Funds' higher blended interest rate, the pension assets must make up the difference between the guaranteed rate of return and the actual rate of return, amplifying the magnitude of losses to the pension fund. Any unexpected losses eventually increase the city's pension contribution, while unexpected gains lower it.

The Mayor's financial plan—with guidance from the Office of the Actuary—now includes a change in methodology for the way that Fixed Return Funds' TDA interest appears on the plans' balance sheets. In past years, the interest owed to the Fixed Return Funds was treated as a cash transfer; money was deducted from the plans' corpus funding the same way a fund's payroll or administrative expenses might be. The new methodology would instead allow the interest payments to be treated as investment expenses. The effect of this change is that TRS and BERS will be able to consider any deviations from the Fixed Return Funds' planned 7.0 percent and 8.25 percent returns to be an actuarial gain or loss, rather than cash added to or removed from the plans' assets.

The City Actuary determines how much money the city, as the sponsor of the pension plans, must contribute to the pension plans in a given year based on a set of assumptions about the plans' assets at the start of the year, how much their assets will grow each year,

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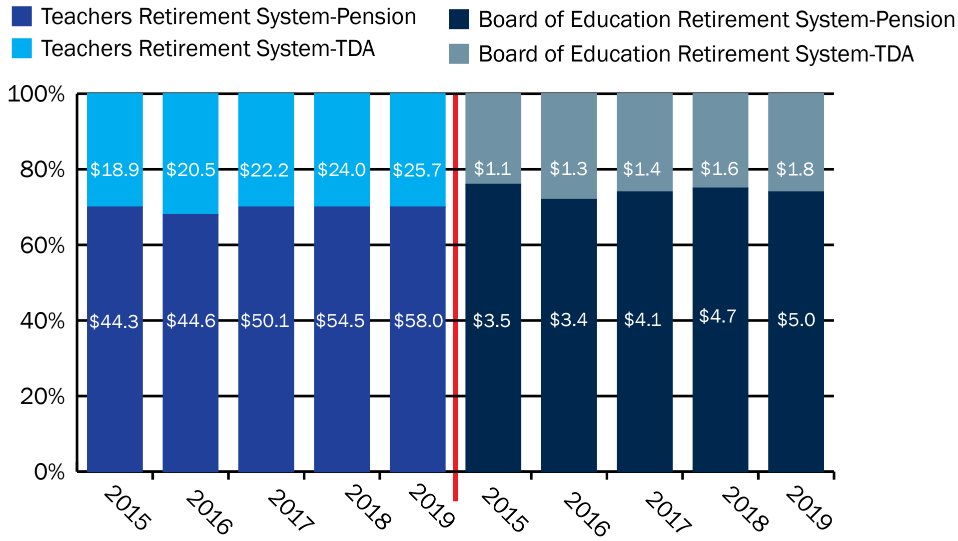
and how much the plans owe to future retirees. When actual experience diverges from one of these assumptions and the plans' assets do not meet the actuary's benchmarks, the city is responsible for covering the shortfalls. When faced with a shortfall, the city is typically allowed to amortize, or gradually make up the deficiency over a number of years. Conversely, when faced with returns that exceed the Actuary's benchmark, the city may reduce its future contributions to the pension funds. Each year the plans' investment returns deviate from the assumed 7.0 percent return rate, the Actuary amortizes the amount above or below 7.0 percent over a period of 15 years. To provide further stability, the dollar amount the Actuary amortizes each year is phased in over a period of six years.

Tax Deferred Annuities Compose More Than a Quarter of Pension Assets
Dollars in billions



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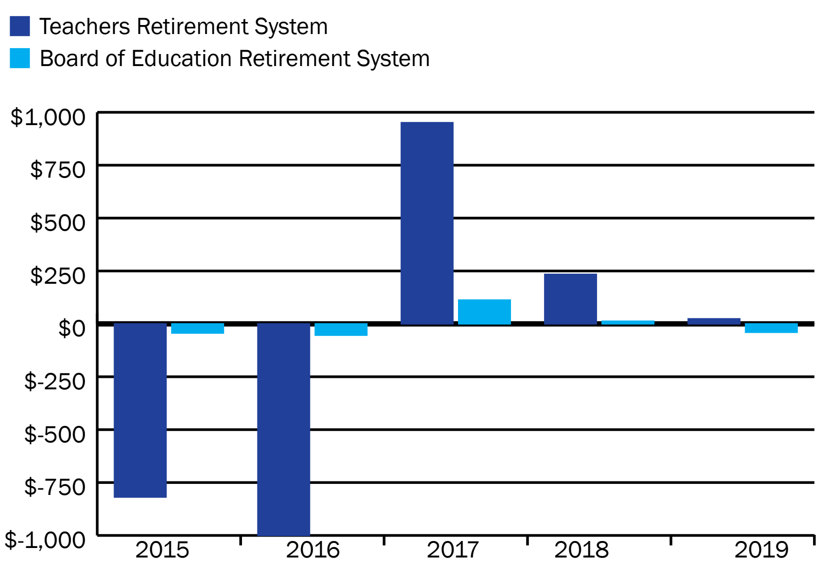
In past years, TRS and BERS considered the investment returns from their pension plans and their Fixed Return Funds without acknowledging the interest due to the funds. For example, if the TRS pension plan earned a 10.0 percent return, then the entire additional 3.0 percent in interest earnings—the difference between the 10.0 percent return and the 7.0 percent planned—was amortized while the interest owed to their Fixed Return Fund was paid separately. Going forward under the new policy, if the pension plan generates a 10.0 percent annual return on investments, the plan will first reduce the earnings by the amount of interest owed to the Fixed Return Fund, and only the remaining returns in excess of 7.0 percent will be amortized.

The Office of the Actuary projects that this accounting change will save the systems $2.5 billion in the long term. Because this is a change in actuarial assumptions, the $2.5 billion will be amortized over 20 years, reducing the city's pension obligations by $125 million annually. But achieving these savings will also depend upon the pension funds hitting their return on investment targets.

Prepared by Robert Callahan

Net Investments Due to Tax Deferred Annuities Are Volatile
Dollars in millions



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