Fiscal Note

BILL # SB 1268

TITLE: PSPRS; deferred retirement option plan

SPONSOR: Livingston

STATUS: As Amended by Senate FIN

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Description

The bill would increase the maximum participation period in the Public Safety Personnel Retirement System (PSPRS) deferred retirement option plan (DROP) from 5 to 7 years. During the additional 2-year time period, the interest credited to the member's DROP account would be based on the PSPRS system's 7-year smoothed rate of return, but the rate cannot be less than 0% or greater than 9%.

Estimated Impact

The increase in the maximum DROP participation period could have 2 fiscal impacts: 1) A change to the PSPRS actuarial funded status, which would impact the system's contribution rates; and 2) An employer's direct payroll costs, depending on employees' employment decisions resulting from the change in the DROP program.

The bill is not expected to have a significant impact on the PSPRS actuarial funded status, based on current PSPRS actuarial valuation practices and assumptions.

The bill could impact employer payroll costs depending on how it changes employee behavior, but that impact cannot be determined.

Analysis

Under the DROP program, a member who reaches the normal retirement age is allowed to make a voluntary and irrecoverable election to participate in the program. From that date, the member works through the end of the selected time period (not to exceed 5 years under current law). During that time period, the member accrues no additional benefits and there are no further employee or employer contributions made. The member's normal pension benefit is paid into a DROP participation account, with monthly interest credited to the account at the PSPRS assumed rate of return (currently 7.3%). At the end of the DROP period, the member's employment ends and the member receives the accumulated pension payments plus the credited interest. DROP participation is limited to Tier 1 PSPRS members (hired before January 1, 2012).

Based on current PSPRS actuarial valuation practices, participation in DROP is generally viewed as cost neutral. Using the example of a Tier 1 member who reaches the normal retirement age after 20 years of service, the PSPRS actuarial status is viewed as the same between 2 scenarios under current law:

- The member enters the DROP program and PSPRS starts a lifetime benefit calculated on 20 years of service, with the first 5 years of payments paid into the specific DROP account. While PSPRS must credit the DROP account with 7.3% interest, PSPRS actuaries assume the system realizes an investment return of 7.3%, resulting in no net actuarial cost.
- The member instead works until 25 years of service with no DROP participation. While the member draws a larger annual pension benefit, the member/employer made 5 years of additional "normal cost" contributions in order to fund the larger benefit, resulting in no net actuarial cost.

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Actuarial Impact of SB 1268
Under the bill, a member's maximum DROP participation period would be 7 years, which is 2 years longer than the 5-year period allowed under current statute. During the 2 additional years, the bill requires PSPRS to credit interest to the member's DROP account based on the PSPRS system's 7-year smoothed rate of return, but the rate cannot be less than 0% or greater than 9%.

According to PSPRS, an actuarial study of the 2-year extension would yield the same cost neutral results as the analysis of the current 5-year DROP program. While SB 1268 implements a variable interest rate calculation to be used for interest during the 2-year additional time period, over the long-term PSPRS actuaries assume this provision will produce an interest rate of 7.3% to match the assumed rate of return adopted by the PSPRS Board of Trustees. And if the system realizes an investment return of 7.3% equaling the DROP account interest rate for those 2 additional years, there is no net actuarial cost.

However, SB 1268 may impact PSPRS contribution rates to the extent the above actuarial assumption do not match the system's actual experience.

In addition, given recent significant PSPRS investment performance, the interest calculation for the 2-year DROP extension (7-year smoothed rate of return) over the near-term may be unusually optimistic and above the system's assumed rate of return. To the extent that PSPRS is crediting interest to DROP accounts at rates above the 7.3% assumed rate of return, the system's funded status could experience some negative impact. For reference, the PSPRS 7-year smoothed rate of return from recent timeframes is as follows:

- 12/31/21: 8.99%
- 12/31/20: 7.42%
- 12/31/19: 7.92%

Employer Payroll Impact of SB 1268
The bill's extension of the DROP program from 5 to 7 years may also impact employer payroll costs, depending on how employees respond to the incentives related to the DROP program. As noted before, a member entering the DROP program makes an irrevocable election to remain employed through the end of the selected participation period. An employer's payroll may be impacted under the following example:

- A member with 20 years of service, at a higher rank and pay level enters the DROP program. During the DROP program, the employer would pay that employee's relatively higher salary, however the employer is also relieved of making any PSPRS employer contributions for that member.
- Absent the DROP program, the employer would then hire a new replacement employee, with a lower rank and pay level. The employer would pay that employee's relatively lower salary, but would also be paying the required PSPRS employer contributions for that member.

The interaction described above would occur during the 6th and 7th years of DROP participation authorized under the bill. However, this impact cannot be determined given the variables involved that are unique to each employer, including relative pay scales and that employer's specific PSPRS contribution rate.

Local Government Impact

Local government PSPRS employer groups would also experience the same potential fiscal impacts described above.

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