New York City Independent Budget Office

Focus On:
The Preliminary Budget

March 2021

Proposed Pension Changes Would Bring Near-Term Savings But Higher Future Costs

The city's Actuary recently proposed a slate of changes for the city's five pension systems. The five systems are the New York City Employees' Retirement System (NYCERS), the Teachers' Retirement System (TRS), the Board of Education Retirement System (BERS), and the Police and Fire retirement systems; we refer to them collectively as NYCRS in this brief. These changes to economic assumptions and methodologies would alter the calculation of the city's annual pension contribution. Because of the size of the NYCRS plans, even small changes in assumptions can have big impacts on the city's pension contribution. Prior to the release of the January 2021 Financial Plan, the city's budgeted annual pension contribution to NYCRS for fiscal year 2021 was slightly above $9.8 billion; with the proposed changes in the Mayor's January plan the city's 2021 contribution decreases to $9.4 billion. (Unless otherwise noted, all years refer to fiscal years.)

In order to mitigate the impact of abrupt increases in costs resulting from adjustments in pension assumptions, the Office of the Actuary often bundles changes that result in higher employer contributions together with other measures that affect the employer's pension contribution more favorably. This bundling of offsetting changes into a single package can increase the acceptability of certain costly and politically difficult changes. Included in the current package of changes proposed by the Actuary is a reduction in the NYCRS assumed rate of inflation. This action on its own would greatly increase the size of employer pension contributions across the financial plan period. The Actuary has also proposed a market value restart of the systems' assets, which mostly mitigates the increased costs of the proposed inflation rate assumption change and provides a short-term windfall for the city in its role as employer.

Assuming a Lower Rate of Inflation. One economic assumption that is common to all of the NYCRS pension plans is the expected rate of inflation, which is currently assumed to be 2.5 percent annually. While inflation typically varies from year to year, the Actuary attempts to estimate the average inflation rate over a period of years that reflects the pension systems' long-term liabilities. The current 2.5 percent inflation rate assumption is not in line with recent experience, however. The Consumer Price Index for Urban Consumers (CPI-U) in the New York City region has risen at an annual average rate of only 1.7 percent over the past decade and 2.3 percent over the past 20 years. In response, the Actuary has proposed gradually lowering the systems' inflation assumption from 2.5 percent to 2.3 percent over the next four years, a change that would require state legislation.

Lowering the inflation assumption is intended to address one of the largest systemic problems faced by NYCRS: the Actuarial Interest Rate (AIR). The AIR is the rate the Actuary uses when calculating the cost of future pension benefits in current dollars; it is also the assumed rate of return on the pension funds' investments. Currently, the assumed rate of return for pension investments is set at 7.0 percent, comprised of a 2.5 percent rate of inflation and a 4.5 percent increase in real (inflation-adjusted) returns. When rates of inflation remain low, achieving an average return of 7.0 percent becomes more difficult for the NYCRS pension funds, leading the systems to rely on riskier asset classes that introduce more volatility. By proposing to lower the inflation assumption to 2.3 percent, the Actuary would effectively lower the AIR to 6.8 percent, assuming increases in inflation-adjusted returns remains at 4.5 percent.

Lowering the AIR has significant impacts on the size of the city's pension obligations. By reducing the inflation rate

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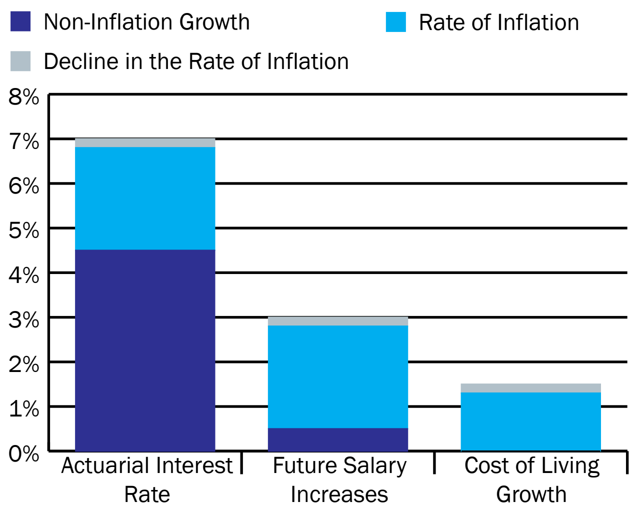
Reducing the Assumed Rate of Inflation Affects Three Formulas



SOURCE: Office of the Actuary

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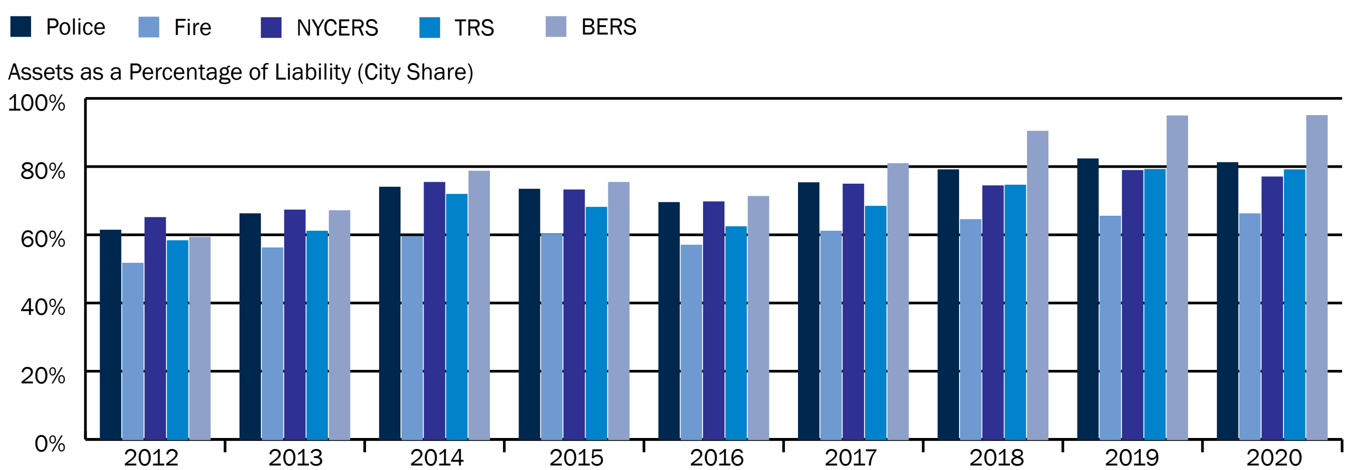
assumption, the Actuary would relieve pressure on the pension boards to achieve unsustainable market returns, but the lower the AIR, the larger the city's unfunded liability. The city, as the employer, is responsible for making up the decline in the systems' assumed future asset values resulting from the reduced assumption of investment growth. For example, according to the most recent Comprehensive Annual Financial Report, reducing the AIR by 1.0 percentage point to 6.0 percent annually would increase the city's share of unfunded pension liabilities from $46.4 billion to $70.4 billion—over a 50 percent increase in the amount owed.

Lowering the inflation rate assumption also has an impact on other formulas that affect the city's pension contribution. The assumed rate of inflation factors into the Actuary's assumptions on future salary increases for employees and cost of living adjustments (COLA) for retirees. The proposed reduction in the assumed inflation rate would reduce the NYCRS assumptions of annual employee salary increases from 3.0 percent to 2.8 percent, and growth in retiree COLAs from 1.5 percent to 1.3 percent per year. This assumption of slower growth in wages and living costs has the effect of slowing the growth of future benefits and thus lowering the city's pension liabilities.

Market Value Restart. The other major change proposed by the Actuary for the NYCRS pension plans is a restart, or resetting of the actuarial value of assets (AVA), setting it equal to the market value of assets (MVA) as of June 2019. The market value of the assets held by the city's pension funds fluctuates from year to year. The market value is the net of the amount of employee and employer contributions to the plans, less the amount of funds paid out by the plans, and the change in the market value of the systems' invested assets. The Actuary currently assumes that the city's pension funds will achieve a 7.0 percent annual return on their investments (the AIR), although it would drop to 6.8 percent if the proposed change to the interest rate assumption is adopted. The city, as the employer, compensates the plans for any shortfall in years when actual returns are lower than AIR, and is given a credit for years in which returns exceed AIR.

These market gains or losses are phased in over six years; the effect of this policy is to prevent one anomalous year of market returns from radically altering the size of the city's pension contribution (see IBO's previous brief on this topic for a more thorough explanation of the phase-in process).

Pension Funding Has Improved Since Last Market Restart



SOURCE: Comptroller's Comprehensive Annual Financial Reports

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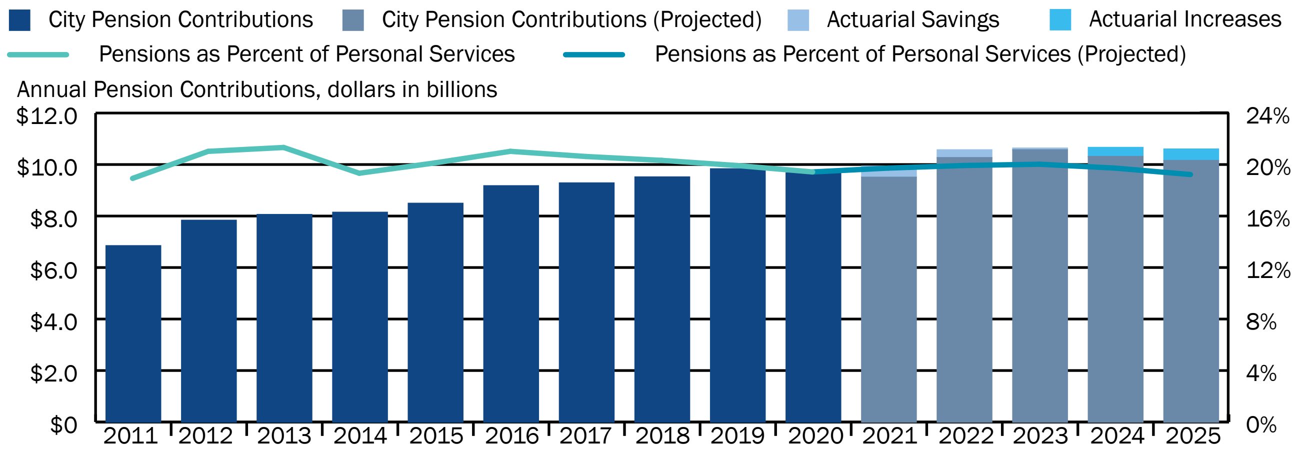
Pension Contributions Stabilized as a Percent of the City's Employee Costs



SOURCES: Mayor's Office of Management and Budget; Office of the Actuary

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After six years, the entire benefit or cost of the deviation from the AIR is accrued in the actuarial value of the funds' assets. Because of this phased accrual, the actuarial value of the pension holdings always lags behind the market value of the pensions' assets. Resetting the AVA to equal the MVA allows the city's pension funds to take the full value of previous years' deviations from the AIR in the current year, instead of phasing them in over six years. Because of the funds' recent success—outperforming the AIR—the value of these deviations has effectively reduced the city's employer contribution. The last reset of the AVA occurred in 2012, setting the actuarial value equal to the June 30, 2011 market value, the cash equivalent of all pension investments at the end of the fiscal year. Since the last market reset, the total funded status of the combined NYCRS plans has improved from 59.9 percent in 2012 to 78.0 percent in 2020, mainly as a result of the plans' exceptional returns.

In light of the city's current economic and financial situation, and the effect that the change in AIR would have on the city's pension contribution, the Actuary has proposed that the plans accrue all unrealized gains and losses from prior years in the current fiscal year, rather than smoothing them in over the next few years. According to the Office of the Actuary, this would lower the cost of pensions for all NYCRS employers— the city and other participating employers like the New York City Housing Authority and the Triborough Bridge and Tunnel Authority— by $556 million in 2021. Going forward, the Actuary recommends that market gains and losses be introduced over a period of five years at a rate of 20 percent per year. All of the changes related to the market value restart must be approved by the individual pension boards.

Budget Impact. The Actuary's pension assumption changes would have an immediate impact on the cost to the city and the affiliated employers. For the city, the net effect of these changes would reduce its current year pension contribution by $430.0 million, the 2022 contribution by $330.5 million, and the 2023 contribution by $65.1 million. The net effect of these changes reverses in future years, with the city's 2024 and 2025 pension contributions increasing by $357.5 million and $443.5 million, respectively. Even with the shifting of costs to the out years of the financial plan, the city expects the recent trend of pension contributions remaining stable as a share of the city's total personal services costs to continue through the financial plan period.

The implications of the Actuary's recommended changes for the city's long-term unfunded liabilities are yet to be determined. In recent years the introduction of more stringent reporting requirements, combined with the creation of a new, less-costly pension tier and a reduction of the AIR from 8.0 percent to 7.0 percent, among other changes, have improved the city's pension funding outlook. While NYCRS' unfunded liabilities have been trending downward in the last decade, unfunded liabilities will at least temporarily increase as a result of reducing the AIR. A benefit of a reduced AIR is that it will allow the individual pension systems to recalibrate the risk of their portfolios, presumably moving to select less volatile asset classes. With more realistic investment goals, the pension systems are also less likely to require sharp increases in required employer contributions in response to future market downturns.

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