Illinois Public Pensions

A pension management and investment newsletter for Illinois pension funds
published by the Illinois Government Finance Officers Association Late Autumn 2007

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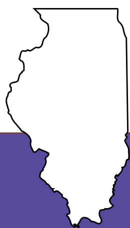

www.igfoa.org

Illinois Public Pensions

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Illinois Public Pensions is published quarterly by the Illinois Government Finance Officers Association (IGFOA),
1120 E. Diehl Rd.,NIU Naperville Campus, Naperville, IL 60563; phone 630-505-0679, www.igfoa.org.

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Annual subscription rates are: Public Sector IGFOA member rate – $35 plus $1 for each additional newsletter to same subscriber;
Associate IGFOA member rate – $50 per year/subscriber; Public sector non-member rate – $100 per year/subscriber;
Private sector non-member rate – $100 per year/subscriber.

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The Evolution of the 457 Market

by Marianne Shank, IGFOA Executive Director and Dave Zahller, Regional Vice President, Security Benefit

The Evolution of the 457 Market

Most governmental employers in Illinois offer a Section 457 Deferred Compensation Plan. Estimates on total plan assets (excluding the State of Illinois, the City of Chicago and Cook County) exceed $1 billion. Despite the significantly growing assets in these plans, when was the last time you took a critical look at the package of features and services your current provider(s) offer? Is your investment menu updated? What about the pricing? How about employee education?

While IMRF and downstate police and fire pensions are core retirement benefit offerings, 457 plans are a crucial component of employees' long-term retirement security. Let's look at how the market has evolved over the years in terms of pricing, servicing, and products and how you may be able to implement additional benefits using existing programs.

"Inadequate governance," Texas Attorney General Greg Abbott says, "will cause a pension fund to nose-dive and crash."

A history of 457 plans

Prior to 1978, public employers establishing deferred compensation arrangements had to use individual private letter rulings from the IRS. Private letter rulings (PLR) are, by nature, specific only to the jurisdiction which obtained the ruling. PLRs should never be used as a guide for any programs offered nationally.

Section 457 of the IRS code was passed in 1978 providing clear guidelines and allowing plans sponsors to adopt 457 plans without expensive filings. Still, during the early years, plan sponsors tended to use nationally endorsed programs to navigate what were still new waters. Initially, plan service was all face-to-face. However, over the next two decades, 457 programs evolved to what most plan sponsors have today—a multi-manager platform serviced largely through call centers

and websites. Periodic onsite enrollment is still offered, but on a plan-by-plan basis. Investment advice was not typically a component of plan design.

Current market trends

The real growth in 457 plans started in the 1990's, which coincided with the one of the strongest bull markets in US history. It was easy for employees without investment savvy to pick a winning mutual fund investment and see it grow dramatically for years.

It became clear in the years between 2000-2002 that many employees left to their own, often allowed emotions to govern their investment choices and did not implement appropriate asset allocation and diversification. Following the market downturn that adversely affected so many public sector employees across the country, employers and providers began looking for plan enhancements to assist with employee financial education and investment advice.

Among the enhancements now available within the 457 environment are:

Online guidance: One of the first services to emerge was providers offering enhanced online services. Provider websites have been expanded to include online resources to provide basic investment education and assist participants in developing a diversified portfolio. Please note online guidance does not include actual investment advice.

Personal advice: A successful plan cannot depend solely on online capabilities of the vendor. Research and surveys continue to indicate that employees want and need the ability to work directly with a registered representative who visits the worksites routinely. Increased plan participation and improved asset allocation are best accomplished by personal onsite service. In many cases, employees need help in determining the correct asset allocation mix for their specific situation and, without, that help frequently don't enroll.

Managed accounts: The latest, well-received benefit in 457 arrangements, is the opportunity for each partici-

pant to hire a professional money manager to control the buying and selling of their investments. This relieves the plan sponsor of perceived liability since each participant can elect to pay extra for this service. Some vendors are using well known money managers such as Morningstar, LLC or Ibbotson. Other vendors have hired their own money managers varying in style from tactical to strategic.

Another area coming to the forefront is plan pricing and control. In the early days of deferred compensation, when all plans were virtually start ups there were often annual maintenance fees, high annualized plan level fees ranging from .85%–1.40%, and deferred sales charges. Now, many of these fees have been eliminated entirely while the plan level fees for the mid-sized and smaller plans can be half or less of what the market could bear a few years ago. This fee reduction is possible due to the increase in plan assets.

Additionally, given increased regulatory scrutiny around "pay to play" arrangements in the financial services industry, plan sponsors are reconsidering their decision to utilize endorsed programs in favor of local control. Today, even small employers have $1+ million in 457 plan assets with many plans exceeding $3, $5, even $10 million in assets. As plan assets grow, it becomes more important from a fiduciary perspective to ensure your 457 plan(s) is still competitive.

One way to "test the market" is to issue a Request for Information (RFI) and see what other firms can offer in terms of investments, service, and pricing or, for a larger plan, hiring an outside consultant. There are Illinois-based based firms, for instance, not affiliated with any product providers which can match public sector requirements to an investment company best capable of meeting those needs.

Stock market strength tends to result in investor complacency and 457 plans do not involve employer dollars. These two features frequently keep 457 plans on the back burner of things-to-do. Recent market volatility should remind us all that markets go up and down, and the time to prepare for a down-market is before it starts.

Does your plan provide your employees the resources they need to successfully manage their 457 account in changing markets? If you're not sure, now is a very good time to find out.

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Section 401(a) plans—an overlooked benefit

By Dave Zahller, Regional Vice President, Security Benefit and Josh Schwartz, Chief Operations Officer, Retirement Plan Advisors

Would your board react positively if the next time you increased employee compensation, you reduced the budgeted cost for the increase 15-20%? Would they be interested in a recruitment tool to attract and retain quality employees? How about a lower cost early retirement incentive?

If you answered yes to any of these questions, you should consider an IRS Section 401(a) Defined Contribution Plan.

IRS Section 401(a) refers to the section of the tax code related to public sector pensions. Broadly speaking, these arrangements are divided into defined benefit pensions and defined contribution pensions. While in Illinois, the primary retirement benefit vehicles are defined benefit plans (IMRF, SLEP, and downstate police and fire pensions funds), defined contribution plans offer opportunities to provide retirement benefits targeted to either a specific group of employees (senior mangers, elected officials, etc.) or a specific purpose such as an early retirement incentive.

A 401(a) defined contribution plan offers many of the

benefits of a 401(k), without the many of the restrictions. As a public employer, you are exempt from ERISA. Therefore, you can discriminate between employee groups (limit eligibility to certain group) and/or create different contribution formulas and still keep the tax advantaged status of the plan.

401(a) defined contribution plans are very popular with employers and employees alike. Employer contributions are not subject to payroll taxes and employees benefit from the on-going tax deferral. In the past few years, public sector employers have implemented many very popular and creative 401(a) defined contributions. Among the benefits are:

Employer benefits

- Contributions not subject to FICA or FUTA
- Contributions can be subject to a vesting schedule on the 401(a) to help retain employees and reduce costs in the future
- Full control over eligibility & contribution formula
- Employer contribution is highly visible to the employee

Employee benefits

- Earnings grow tax deferred
- Investments in the 401(a) are employee-directed
- 401(a) assets can be rolled over to an IRA or new employer's plan
- 401(a) assets pass to the employee's beneficiary

Here are four case studies illustrating the use and effectiveness of 401(a) defined contribution plans:

457 / 401(a) match plan

The City of Elgin established a 401(a) matching plan in 1993. According to Jim Nowicki, City of Elgin Finance Director, the matching plan is only offered to the City's 300 non-collectively bargaining employees. All but one participate. The participating employees can contribute

up to 2% of salary into the 401(a) and the City matches 4%. The City has found this to be an effective recruitment and retention tool as they vie for qualified employees. Neither the employee nor the city contribution show up on the salary scale since the contributions to the accounts is non-pensionable. Elgin does not have a vesting schedule but a City can have a vesting schedule in place to insure employees work for a reasonable number of years before they "own" the employer dollars that have been contributed into the program.

The State of Missouri on the other hand will contribute up to $25 per check into a 401(a) if the employee voluntarily contributes a like amount into the 457 Deferred Compensation Plan. Once implemented, the State's participation rate in the 457 rose from 30% to 80% participation. To date, this remains one of the State's most popular benefits.

Targeted incentive

The City of Naperville established their TOP (Time Off Plan) 401(a) Plan to encourage consistent attendance. The City developed a schedule which considered such things as salary and years of service to reward employees who used three or less of days of sick time per year.

The single item that attracted IRS scrutiny in recent years is the use of these arrangements simply to use the contribution to the plan merely to circumvent an employer's Social Security obligation. According to the IRS, a 401(a) plan that consisted solely of the employer contributions of accumulated sick and vacation leave was insufficient and thus did not warrant volume submitter plan status. Further, the IRS cautioned, designing the 401(a) to permit participation by only those individuals who were terminating their employment in the year that they were first eligible would not be considered an acceptable eligibility provision for a volume submitter plan. The key is structuring the plan using employer contributions and not allow the employees the option to receive the contribution in a cash payment. The language of the agreement must indicate that employer contributions will be made into the 401(a) plan.

Terminal pay plan

Do you buy back used sick and/or vacation time from your retiring employees? The Village of Orland Park had a serious issue with large lump-sum payouts to retiring police officers on the command staff. For the Village, the unpredictable number and size of payments to retiring command staff in any given year made accurate budgeting difficult. For the command staff, the lump-sum payout created a substantial tax liability they wanted to avoid.

The solution was to establish an employer-funded 401(a) plan with unused sick-time as the contribution. Each officer is required to keep a minimum of 400 hours is the "sick bank" to ensure that paid time off is available if needed. Each year up to 25% of the total sick-time hours accumulated not too reduce the sick-bank below 400 hours is contributed to the 401(a) plan.

The Village is not only benefiting from a predetermined funding schedule which improves budgeting, the contributions are not subject to pension, social security or Medicare saving significant dollars. Additionally, dollars are paid out at today's salaries, not tomorrows and no longer have to be carried as a liability on the books.

The Command Staff benefits by receiving tax-deferred market growth for the remainder of their working careers and into retirement on the value of their accumulated sick-time rather then receiving COLA growth and having it taxed as a lump sum at retirement.

In closing, since IMRF, SLEP, and the public safety pension funds are the primary retirement vehicle in Illinois, many employers overlook the potential cost savings and benefits available with a 401(a) plan. Used properly, a 401(a) plan can enhance the employee's benefit package and reducing the employer's cost at the same time!

The information contained herein should not be construed as tax planning advice. Please consult a qualified tax advisor for such advice.

Girard Miller on deferred comp plan kickback lawsuits

by Girard Miller

Is somebody taking a cut of your employees' retirement savings?

In the public pension world, occasional convictions over kickbacks have been a black eye for a generally clean industry. Money and politics go hand in hand, but when money is held in trust for the exclusive benefit of retirees and plan participants, a higher standard of duty is required by law. It's called the "duty of loyalty" by the fiduciary bar. Simply put, the law requires that trustees and administrators of retirement systems put the interests of the plan participants first—always.

In the world of defined contribution and deferred compensation plans for state and local governments, the same ethical and legal rules should apply. Particularly when it comes to endorsements.

Heads have been turning lately in light of a lawsuit alleging "kickbacks" through an endorsement deal between a teachers' 403(b) plan administrator and the National Education Association.

The suit alleges that 57,000 schoolteachers are being overcharged as a result of the arrangement.

This isn't the only endorsement deal in the public-sector defined contribution market. Other governmental, labor and professional associations have participated in various arrangements that favor one vendor or another, with differing degrees of due diligence and financial support. Other lawsuits have been filed making similar allegations, and the New York attorney general's office conducted an investigation of another such arrangement which resulted in a multi-million-dollar settlement payment.

If plaintiffs prevail in the NEA case, the door will likely open even wider to similar litigation elsewhere.

Ordinarily, state and local government plans are exempt from provisions of the federal Employee Retirement Income Security Act (ERISA). The courts could still find a violation of fiduciary law, however, because the duty of loyalty is deeply ingrained in all benefits trusts. Moreover, the SEC is scrutinizing '12b-1' marketing fees charged by mutual funds, and similar arrangements. Further, there is already class-action investor litigation pending in federal courts on similar charges involving marketing and administrative payments to third parties by mutual funds. Finally, if a scandal draws their attention, Congress or the IRS could take a dimmer view of these deals and tax them as 'unrelated business income' instead of tax-exempt royalties.

Facing tight budgets, some local governments have asked their recordkeepers and plan administrators to make contributions to their DC plans for administrative costs and to pay for the fees of the consultants who select them (!). In essence, the employees are paying for the employer's expenses of plan administration. While these arrangements are well-intended, and the U.S. Department of Labor has accepted similar arrangements in the private sector, it would not take much of an extension of the logic of the pending fee litigation to put these employers in legal jeopardy for commandeering employees' money. Most vulnerable would be plans that require mandatory employee contributions, not just optional savings.

These lawsuits and investigations may compel changes in marketing arrangements and fees. Meanwhile, public officials, trustees, plan administrators and association boards would be prudent to ask probing questions about endorsements, "reimbursements" and marketing fees in their defined contribution and deferred compensation plans. Plan websites, plan documents and investment materials sent to employees should make full disclosure in specific, aggregate dollar terms as well as per-investor.

Associations making endorsements or granting exclusive "partnership" or "sponsorship" status for a fee, royalty or similar franchise right should prominently disclose the deals and the dollars on their tax-exempt websites. At least one vendor, a major insurance company

subsidiary named in similar litigation, has reportedly made such a disclosure of a $7 million endorsement deal in an honest effort at transparency on its part—yet ironically the recipient association apparently has not followed suit.

The National Association of Government Defined Contribution Administrators' (NAGDCA) annual meeting next week might consider proclaiming full disclosure an industry best practice and a recommended condition for bid awards, especially if the members take their fiduciary responsibility seriously.

If anything could attract unwanted federal regulation of state and local government benefits management, federal taxation of these nonprofit association revenues, or more class-action lawsuits, it would be hidden deals with privileged fees. How can public-sector associations tell the feds to stay out of their back yards on retirement plan oversight if they are pocketing money on the sly?

As they say, "sunshine is the best antiseptic." Professionals, both public and private, can hold their heads a little higher if everybody steps up to full disclosure—and watches every penny of fees.

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This article appeared in the Governing Management Letter at Governing.com and can be found at http://www.governing.com/articles/11gmillera.htm

403(b) rules updated for school districts

School districts are encouraged to review the IRS final regulations for 403(b) plans and to consult with their plan manager. These regulations generally apply for taxable years beginning after December 31, 2008. Find detailed information at http://benefitslink.com/taxregs/-final_403b.pdf

Differences between planned and actual retirement

Prepared by the Employee Benefit Research Institute (EBRI) and Mathew Greenwald & Associates

At what age do workers say they plan to retire? And when do they actually retire? Has that changed over time?

The 17th annual Retirement Confidence Survey (RCS) shows that the age at which workers say that they plan to retire has slowly crept up—from a midpoint of age 62 in 1996 to age 65 in 2006 and 2007. The RCS also finds that many retirees left the workforce earlier than they expected, for negative reasons.

Among workers, about 4 in 10 plan to retire before reaching age 65; 17 percent say they will retire before age 60; and 21 percent plan to retire between the ages of 60 and 64. More than one-quarter of workers say they will retire at age 65 (27 percent), while another quarter intend to retire at age 66 or even later (24 percent).

But for the average retiree, the actual age of retirement increased from age 60 in 1996 to age 62 in 2006 and 2007—which indicates that current retirees left the work force earlier than current workers expect to. The RCS also finds that many retirees who retired early cite negative reasons for leaving the work force before they expected, including health problems or disability (28 percent), changes at their company, such as downsizing or closure (28 percent), and having to care for a spouse or family member (25 percent).

Comparative data are in the table below:

Planned and Actual Retirement Age

	Workers (Planned)	Retirees (Actual)
Before 55	7%	14%
55–59	10	21
60–61	10	7
62–64	11	25
65	27	13
66 and older	24	15
Never retire/never worked	6	3
Don’t know	5	0

Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2007 Retirement Confidence Survey.

The RCS also finds that workers who are not confident about their financial security in retirement plan to retire later, on average, than those who express confidence. Others planning to retire later include workers in excellent, very good, or good health, those not expecting benefits from a defined benefit plan, private sector workers, women, and those with less than $75,000 in household income.

The Retirement Confidence Survey is sponsored by the nonpartisan Employee Benefit Research Institute (EBRI) and Mathew Greenwald & Associates, a survey research firm. Established in 1978, EBRI is an independent nonprofit organization committed exclusively to data dissemination, policy research, and education on economic security and employee benefits. EBRI does not take policy positions and does not lobby. Full survey results are available at http://www.ebri.org/surveys/rcs/2007/.

Trustee attributes and core competencies

- Each trustee should **have a thorough understanding of the fund's obligations** to its beneficiaries, the fund's economic position and strategy, and its relevant governing principles. Each trustee must be able to make decisions based solely on the objective requirements of the trustees' fiduciary duties to fund beneficiaries. Each trustee should be inquisitive and should appropriately question staff, advisors, and fellow trustees as circumstances require. Each trustee should also contribute to a balanced set of skills that enables the board, acting as a collective body, to execute successfully its obligations.

- The board should at all times **include individuals with investment and financial market expertise** and experience relevant to the fund's ability to exercise its fiduciary obligations to its beneficiaries.

- Trustees, on a regular basis, should **obtain education that provides and improves core competencies,** and that assists them in remaining current with regard to their evolving obligations as fiduciaries.

- Trustees should be able to **obtain intelligible explanations** of recommended actions from staff, advisors, or colleagues.

- The fund should **engage in an annual evaluation of trustee skills** and, where appropriate, should develop a plan for improving and expanding the board's competencies.

From The Stanford Institutional Investors' Forum Committee on Fund Governance Best Practice Principles.

Read more at http://www.law.stanford.edu/program/executive/programs/Clapman_Report-070316v6-Color.pdf

Social Security offsets: Policies public employees love to hate and don't understand

By Thomas Margenau, ©2007 International Foundation of Employee Benefit Plans

Do you administer a public pension for employees not covered by Social Security? If so, you may be aware of two laws that can offset, or perhaps eliminate, Social Security benefits employees may have earned on the side or may be due from a spouse. Questions are understandable, given the complexity of these laws: the windfall elimination provision and the government pension offset. This article intends to clarify these government offsets.

"I've heard through the grapevine that my Social Security will be cut in half because of our pension plan. What's the deal?"

"A co-worker just told me that I won't get a nickel of my wife's Social Security because of our pension. That isn't fair!"

"I understand an offset will prevent me from getting any Social Security. But surely I'll be covered by Medicare, right?"

The above questions and comments may be heard from those who work in the benefits or payroll department of a public agency not covered by Social Security. Conventional wisdom usually places the blame for these perceived Social Security benefit inequities on a law vaguely referred to as a government offset.

In fact, there are two provisions in Social Security law that may potentially impact employees due to receive a pension from a job not covered by Social Security. The first is the windfall elimination provision, which generally reduces a public employee's own Social Security retirement benefit. The second is the government pension offset, which impacts any Social Security spousal benefits employees might be due from a wife or husband's Social Security record. Employees may be affected by one or both of these laws.

Two provisions

Most local and state government employees, as well as a growing share of federal employees, pay into Social Security just as everyone else does. In fact, approximately 70% of all state and local government jobs (including teachers in most states) are covered by Social Security.

However, for those representing a portion of the 30% of public employees not covered by Social Security (including teachers in some states such as California and Texas), these laws will play a major role in pension and retirement planning.

If employees receive a pension from a job not covered by Social Security, but they have paid enough Social Security taxes in other jobs to qualify for a Social Security retirement benefit, that benefit will likely be reduced due to their government pension. The law requiring this reduction is the windfall elimination provision.

That same government pension will offset, and usually eliminate, any Social Security benefits employees may be due on a spouse's Social Security record. The law requiring this reduction is the government pension offset.

Why are most jobs covered by Social Security While others are not?

When the Social Security Act was passed in the mid-1930s, most workers in commerce and industry did not have any type of retirement pension plan. Because they were expected to directly benefit from Social Security, they were covered by the new law. Over the next several decades, other large employee groups, such as farm workers and military personnel, were also covered under the Social Security umbrella. In the mid-1950s, the self-employed were added to the Social Security rosters.

Certain large employee groups, such as federal government employees and railroad workers, had already established pension plans before Social Security was added. Therefore, Congress decided to exclude them from Social Security. Also, at the time of Social

Security's enactment, Congress felt it could not mandate a federal pension plan (Social Security) on state and local government entities, so employees of these agencies were given the choice of participating in Social Security. Of course, many of these entities established their own pension plans intended to operate independently of Social Security.

While many small and large government agencies did not accept Social Security coverage, over the years a high percentage of all state and local public employees opted to join the Social Security system. In 1983, sweeping changes altered the Social Security landscape following the recommendations of a presidential commission. All federal employees hired after December 31, 1983 were included in Social Security as were members of Congress, the president and vice president. State and local government employees were forbidden to terminate Social Security coverage after April 20, 1983. So today, railroad workers, a diminishing number of older federal government employees and about 30% of state and local public employees are the only large groups of workers in the United States not covered by Social Security.

That same presidential commission recognized that certain inequities in Social Security benefit payments were the direct result of these Social Security coverage issues. Public employees who worked for a relatively short time under Social Security received a windfall in Social Security retirement benefits that was intended only for long-term lower income workers. Many public employees were receiving spousal benefits from a husband's or wife's Social Security record although they did not meet the legal definition of dependency associated with those benefits. The result was, the commission recommended the passage of the two laws that became known as the windfall elimination provision and the government pension offset to deal with these inequities.

Windfall elimination provision

The windfall elimination provision reduces an employee's Social Security benefit, generally by about one-half. In other words, if the computerized estimate an employ-

ee impacted by this provision receives from the Social Security Administration indicates he or she is due $400 per month in a retirement pension upon reaching Social Security's full retirement age, that person can likely expect to receive about $200.

This is a very important point because if the Social Security Administration does not know if a potential retiree is impacted by the windfall elimination provision, it does not use the modified retirement benefit formula when sending annual benefit estimate statements. Therefore, retirement estimates in the Social Security statements sent to employees impacted by the windfall elimination provision are most likely wrong.

The key to understanding this provision is to realize that the word "social" in Social Security means something. Unlike private and other public sector pension plans, there are social goals built into the Social Security program. One of those goals is to raise the standard of living of lower income workers in retirement. This is accomplished through a benefit formula designed to give lower-paid workers a better deal than their more highly paid counterparts. Very low-paid workers could get a Social Security retirement benefit that represents up to 90% of their average lifetime earnings. This percentage is known as a replacement rate. In other words, Social Security benefits paid to the lowest-paid workers in our society are intended to replace 90% of their pre-retirement earnings. Those with average incomes (the middle class) generally get a 40% replacement rate. Those with higher incomes get a rate of approximately 30%.

The actual benefit formula the Social Security Administration uses to figure Social Security retirement benefits is updated annually and is further complicated by variables that are different for each year of birth. For example, a worker who turns 62 in 2007 would take the first $680 of average monthly earnings and multiply it by 90%; the next $3,420 by 32%; and the remainder by 15%. The Social Security Administration publishes a fact sheet, "Your Retirement Benefit-How It Is Figured," that explains the benefit computation formula. It is available on the Social Security Administration's Web site at www.socialsecurity.gov/pubs/10070.html.

In the author's opinion, the problem is that government employees and others who spend the bulk of their working lives not paying into Social Security are automatically treated as low-income workers by the Social Security Administration's computers. This is due to zeros on their Social Security earnings record for every year they spent in a non-Social Security job. Social Security's records don't show that they were actually working at another job and earning another pension. Instead, their Social Security earnings record simply shows gaps in their work history. So, when figuring their Social Security retirement benefit, the Social Security Administration's computers automatically use the formula intended to compensate a lower-income person. However, government employees can generally be classified as having average incomes, so they should get the same Social Security replacement rate paid to all middle-class workers. This is why a modified formula is used to refigure their benefits and give them the proper, and fair, replacement rate. For public employees impacted by this law, this modified formula replaces the 90% benchmark in the first step of the Social Security retirement formula with a smaller rate of usually 40%. The desired effect is to eliminate the windfall paid to middle-class public employees usually intended for lower-class workers (thus the name windfall elimination provision). Or, in other words, the windfall elimination provision takes a public employee from the 90% (low-class) replacement rate to a 40% (middle-class) replacement rate.

What does that mean in real money?

If an employee is affected by the windfall elimination provision, there is a simple formula that can be used to refigure his or her benefit. For example, if the retirement estimate in his or her Social Security statement is $612 or more, subtract $340 (or half of the public pension, whichever is less). If the retirement estimate in his or her Social Security statement is $611 or less, multiply the estimate by four and divide by nine.

The Social Security Administration has an online calculator for those impacted by the windfall elimination provision. It can be found at
www.socialsecurity.gov/retire2/ anyPiaWepjs04.htm.

An exception to the windfall elimination provision

The modified windfall elimination provision formula shown above applies only to people who have 20 or fewer years of substantial Social Security earnings.

If an employee has 30 or more years of substantial Social Security earnings, the windfall provision won't apply and the employee's Social Security benefit will not be reduced. If an employee has between 20 and 29 years of substantial earnings, his or her Social Security benefit will be only partially reduced. Instead of being cut roughly in half, it will be reduced by about 5% to 45%, depending on the number of years of substantial earnings on the person's record. The more years of earnings, the less the reduction will be. The online windfall elimination provision calculator on the Social Security Administration's Web site will figure the reduction that applies.

There are other exceptions that apply, such as for railroad workers, some employees of nonprofit organizations and those who worked in non-Social Security jobs prior to 1957. For a complete list of exceptions, see www.socialsecurity.gov/pubs/10070.html.

Why some employees may want a second job

Some employees may not be eligible for a Social Security retirement benefit (windfall elimination provision or not) if they do not have the 40 credits necessary to qualify for such benefits. However, employees who have close to 40 credits should consider taking a part-time job just to get over the threshold. With 39 or fewer credits, an employee won't collect a nickel from Social Security. With 40 or more credits, he or she will collect a benefit that will be subject to the windfall elimination provision and may be reduced to an amount less than $100 per month. And $100 in nickels is better than no nickels at all.

An employee can take a part-time job earning as little as $4,000 per year and receive four credits from Social Security. (That's the maximum payable in any one year.) Public employees significantly under the 40-credit threshold will have to decide if it is worth the effort to work at a Social Security-covered job for up to ten years to qualify for a very small monthly payoff from the system.

Government pension offset

The windfall elimination provision impacts an employee's Social Security retirement benefit. The government pension offset impacts Social Security spousal benefits and affects employees who will collect a pension from a job not covered by Social Security.

The government pension offset essentially states that a public pension paid to employees not covered by Social Security will offset (and generally eliminate) any benefits they may be due on a spouse's Social Security record.

The simple government pension offset formula

Unlike the complicated windfall elimination provision discussed above, the government pension offset formula is simple; the Social Security Administration must deduct an amount equal to two-thirds of an employee's government pension from any wife's, husband's, widow's or widower's benefits he or she might be due from Social Security. Because public pensions are often substantially higher than spousal benefits paid under Social Security, this rule generally means that an employee impacted by the government pension offset will not qualify for any benefits on a spouse's Social Security record.

Why the offset?

Benefits that Social Security pays to wives, husbands, widows and widowers are dependent's benefits. These benefits were established in the 1930s to compensate spouses who stayed home to raise a family and were financially dependent on the working spouse. However, as more and more couples became employed, they each earned their own Social Security retirement benefits. Social Security law has always required Social Security Administration to offset one retirement benefit against another. For example, if a woman worked and earned her own $800 monthly Social Security retirement benefit but she was also due a $500 wife's benefit on her husband's Social Security record, the Social Security Administration could not pay that wife's benefit because

her own Social Security benefit offsets it. However, if that same woman was a government employee who did not pay into Social Security and earned an $800 public pension, there was no offset (prior to the government pension offset law) and the Social Security Administration was required to pay her a full wife's benefit in addition to her government pension. The government pension offset rule exists to ensure that employees who collect public pensions are treated the same way as those who collect Social Security retirement pensions.

Exceptions

There are a few exceptions to the government pension offset. They apply primarily to state and local government employees whose public pension was based on a job where they were paying Social Security taxes during the last five years of their employment, or to "civil service offset" employees. (A civil service offset employee is a federal employee with at least five years of prior civil service experience, rehired in 1984 or later following a break of more than one year in government service.) For a complete list of exceptions to the government pension offset rules, see the Social Security Administration's Web site, www.socialsecurity.gov/pubs/10007.html.

An example that explains the fairness of the government pension offset

Many public employees impacted by government pension offset think the law is unfair. They believe they are being cheated out of Social Security benefits that everyone else receives. For example, Bob and Carol-and their neighbors, Ted and Alice—live in a nice suburb of San Diego. Both Bob and Carol worked all of their lives at jobs covered by Social Security. In other words, Social Security taxes were deducted from both of their paychecks.

Ted also worked at a job covered by Social Security, however, his wife, Alice, was a teacher in San Diego. California teachers pay into the state teachers retirement system, but they do not pay into Social Security.

Bob retired and is receiving $1,200 per month in Social Security retirement benefits. For most of her life, Carol actually made more money than Bob, so she is receiving a Social Security retirement pension of approximately $1,500 per month. Carol cannot receive (and frankly, doesn't expect) any wife's benefits on Bob's record because her own Social Security benefit precludes any spousal payments. In other words, Carol's own retirement benefit offsets any wife's benefits she may have been due on her husband's record. In addition, Bob cannot receive a husband's benefit on Carol's record because his own retirement benefit would offset it.

Ted is receiving roughly the same Social Security benefit as Bob, about $1,200 per month. Alice is receiving a $3,000 monthly California teacher's pension. Before the government pension offset was in place, Alice would have received a $600 dependent wife's benefit from Social Security in addition to her comfortable teacher's pension. But again, the government pension offset prevents this from happening. Yet Alice, reflecting the views of many public employees, is upset because she cannot receive a wife's benefit on Ted's Social Security record. Alice believes she and other government employees are being singled out for Social Security penalties. What she doesn't understand is that the law treats her the same way her neighbor Carol is being treated. Again, it says that neither woman will get a dependent wife's benefit from Social Security because each is receiving her own retirement pension.

An important Medicare message

Although employees may not qualify for monthly cash benefits on a spouse's Social Security record (because of the government pension offset), they can still receive Medicare on that spouse's record, assuming they are aged 65 or older and cannot receive Medicare on their own records.

Reprinted from the Summer 2007 newsletter of the National Association of Government Defined Contribution Administrators (NAGDCA). Visit http://www.nagdca.org/

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OPEB obligation bond funding strategies offer risks & rewards

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Identifying and quantifying other post employment benefits (OPEB) liabilities has been a laborious process for many government entities. Some are finding a potentially significant unfunded liability because most governments handled these costs on a pay-as-you-go (PAYGO) basis and assets were not set aside to fund future costs.

With the onset of GASB 43 and 45 (GASB 45 in fiscal 2008), public sector employers are required to account for OPEB expenses in a method similar to pension benefits. Under the new statement, OPEB liabilities and the corresponding annual required contributions (ARC) would be actuarially determined. We now have some clarity on the magnitude of state OPEB liabilities, which are sizable for many, and in some cases, exceed the level of their unfunded pension liabilities.

OPEB obligation bonds (OPEBOBs), a prefunding strategy, are one solution for funding a government's OPEB costs, although many governments are not yet considering this option until they are certain of their OPEB liability. OPEBOBs could be a viable option only if all risks are considered and actively managed. GASB does not require governments to fund their OPEB liabilities; however, GASB 45 allows governments that advance fund liabilities and establish qualified OPEB trusts to discount future benefit payments using a discount rate that reflects the earning assets in the trust fund. This dramatically lowers the government's OPEB liability.

However, as with all debt, there are risks to consider. For example, if the investment return on invested bond proceeds is less than the OPEBOB interest cost, the transaction becomes a drag on cash flow since an unfunded actuarial accrued liability (UAAL) could re-emerge. The government must also determine whether incurring a hard liability for OPEB liabilities makes sense given the vagaries of health care costs, other capital improvement priorities, and the political climate. OPEBOBs can become a political issue if the OPEB is sold to the public as a complete solution to the government's OPEB problem.

Health care costs: The big unknown

The validity of a government's OPEB liability centers on numerous actuarial assumptions, but one assumption in particular, the health care cost inflator, is the big unknown factor because it could be key to a government's OPEB liability. Health care costs have long been a major cause for concern in all municipal budgets and are an important component in any issuer's OPEB liability. The sustained rates of health care cost increases, in many cases at double-digit levels, have resulted in OPEB costs accounting for an increasing share of governmental operating expenses. As the expected rates of cost increases are projected into the future, the associated liabilities grow even faster.

Since governments began establishing OPEB liabilities through actuarial methods several years ago, Standard & Poor's has seen wide variability of OPEB valuations. However, the long-term growth rate of health care costs appears to confound analysis, driving the OPEB liability significantly higher or lower. Actuaries typically assume that health care cost growth will average 10%-12% annually over the next 10 years, and 5% annual growth thereafter. Health care experts and casual observers continue to debate this growth assumption since costs have been increasing 10%-20% annually for the last decade.

In comparison to OPEB valuations, determining pension liabilities is much more precise (although still not exact) based on historic records of employment and salary changes, and demographic trends, among other variables. In addition, the fact that health care recipients are living longer complicates total liability certainty. This

factor is particularly true for those entities with generous, lifetime health care benefit arrangements. Another complicating factor would be a national health insurance plan, which could change the entire equation for governments' OPEB liability, depending on the benefits provided.

Possible solutions

Faced with addressing a large OPEB liability, many government entities are considering a number of options, including:

- Continue using a carefully managed and forecasted pay-as-you-go funding plan;
- Decreasing benefits;
- Closing the existing benefit level for new employees, creating a new tier with lower benefits (as has been done in some cases with pension benefits);
- Seeking to contain health care costs through adjustments to current plans;
- Instituting, or increasing, contributions from current members; and
- Advance funding of a trust fund using OPEBOBs.

Each option has its challenges. In reality, it may not be possible to change an existing plan's benefit structure due to legal or political considerations, among others. For this reason, like pension obligation bonds (POBs), OPEBOB may play a role in reducing OPEB liabilities because issuing could reduce or eliminate an employer's OPEB liability.

OPEBOB credit benefits

Advance funding OPEB by issuing OPEBOBs offers a vehicle for employers to build an asset base to offset the actuarial accrued liabilities and pay benefits as they come due in future years. Contributions to a funded OPEB plan over time should be more stable, if initially higher, than under a PAYGO arrangement because these outlays are directly (immediately) affected by the vagaries of health care costs. While advance-funding the OPEB would not rein in actual health care costs, the flows into the plan should be more predictable because

actuarially funded benefit plans usually attempt to stabilize contribution rates. However, due to the dynamics of the health care industry, actuarially determined contribution rates for OPEB will probably be more susceptible to change than contribution rates for pension benefits.

Real assets growth through advance funding also will provide greater benefit security for employees/retirees, since funding by tangible investments can be measured and monitored. As the asset base builds and the funding ratio increases, a larger share of the revenues in the plan will come from investment income, while the corollary portion from contributions declines. This relationship is part of the design and was the experience in developing U.S. pension trust funds during the last century. Today, reasonably well funded defined benefit pension plans may receive up to 60% to 70% of total revenues from investment income.

Another advantage to employers from advance funding OPEB comes from the potential ability under GASB 45 to use a higher discount rate to value liabilities than under the PAYGO method. Using a higher discount rate would result in lower actuarial liability and expense calculations. For employers that are expected to contribute amounts equal to or greater than the ARC, a discount rate based on the long-term expected rate of return on the OPEB plan's assets would be used. Plan assets would most likely be invested in a portfolio of securities designed to generate a higher long-term rate of return, maybe 7% to 8%, similar to pension trust funds. Employers that have no plan assets would use a discount rate based on its own investments, which may return 1% to 3%. Employers with some plan assets that are expected to contribute less than the ARC would use a blended rate. Therefore, full, advance funding of OPEB through OPEBOBs would generate both real cost savings from investment earnings and more favorable liability calculations.

OPEBOB credit risks

Like POBs, OPEBOBs are typically secured by a traditional pledge: GO or appropriations. The issuer's principal risks for an OPEBOB are similar to POBs and fall into several categories:

- Arbitrage
- Leverage
- Market, and
- Political

OPEBOBs are essentially an arbitrage arrangement, the success of which depends on the premise that the OPEB trust fund assets (including OPEBOB proceeds) will earn on average more than the OPEBOBs' interest cost, and hopefully the assumed investment return rate (generally about 8%) or better each year for the life of the bonds. If the bonds are sold at an interest cost of 6%, for example, the spread could generate savings if the investment returns goals are met over the life of the bonds.

If the OPEB trust fund earns 8% or more on the bond proceeds, the issuer would pay lower OPEB-related costs (contributions plus OPEBOB interest) than without the OPEBOB. However, if the investment return is less than the OPEBOB interest cost, the transaction becomes a drag on cash flow since an unfunded actuarial accrued liability (UAAL) could re-emerge. If returns are above 6% (as in the example above) but below 8%, the employer would have increasing contribution rate costs, but would have had them even without the OPEBOB.

While the 1990s produced some impressive investment returns, they can vary dramatically and may (or may not) average the investment return assumption or even the OPEBOB interest rate cost. For this reason, an OPEBOB's full effect can only be known at the bonds' final maturity. Since our experience with OPEBOBs is limited--only a handful has been issued to date—the POB market is instructive. Many POBs have appeared successful for several years, or even a decade, only to have investment gains eroded.

Conversely, after poor results in the early years, POBs achieve projected benefits in the final analysis. In any

event, we do know that even if projections are met on average over the life of the OPEBOBs, there will be years of higher returns, and some that are lower (maybe significantly), than the 8% investment hurdle. We do not have to look back very far to see evidence of such swings: in fiscal 2001, the S&P 500 index of domestic equities fell 16%, in 2002, it fell another 19%, but in 2003, it fell only 1.6%. These market declines hurt issuers with POBs outstanding: most had to pay increased contribution rates to cover the new actuarial losses and they had the higher debt service costs due to issuing the POB.

Because OPEBOBs, like POBs generate very large infusions of cash into a trust fund compared with the more steady investment and reinvestment of interest, dividends, and contributions, the plan for investing OPEBOB proceeds must be considered. Should the monies be invested according to the existing asset allocation guidelines, or should OPEBOB proceeds have a different asset allocation strategy because of the nature of the liability? In fact, OPEBs are paid out differently than pension benefits, with the majority of cash flow needed in the period immediately after an employee's retirement and before Medicaid eligibility. However, most pension benefits are paid at a level rate throughout the retiree's remaining lifespan. Furthermore, the issuer needs to think through ongoing fund management and determine who would have fiduciary responsibility for managing the investments.

Adding too much leverage is another risk factor for OPEBOB issuers to consider. Borrowing for any purpose increases leverage, and incurring debt to pay unfunded liabilities is no different. While the issuer is substituting one type of long-term liability (OPEBOB) for another (OPEB UAAL), there is a difference. In most cases, bond debt service is a "hard" obligation compared with the "softer" contribution payments used to amortize the UAAL. Bond debt service must be paid in full and on time or the issue falls into default, with wide ramifications. Conversely, employers' contribution payments to a pension or OPEB trust may be temporarily deferred or reduced without serious negative consequences.

However, risks and opportunities are also associated with "softer" obligations. A soft obligation may be deferred during a temporary period of reduced liquidity resulting from a one-time unexpected expenditure or an unexpected dip in revenues. The obligation may be deferred until fiscal balance is restored to bring payment of the obligation back on schedule, resulting in no credit impact. Unfortunately, soft obligations may also be deferred for political expediency, creating significant credit issues if this deferral is practiced over successive periods. A hard obligation could lead to better long-term fiscal stability if political deferrals are a real risk. Regardless of the political climate, the size of the OPEBOB relative to the issuer's total debt structure must be measured in terms of what level of debt service can be managed if actual future investment returns do not meet the original OPEBOB plan projections.

As we have seen with POBs, OPEBOBs can become a political issue if the OPEB is sold to the public as a complete solution to the government's OPEB problem. For example, if an OPEBOB is issued for the full UAAL, resulting in a 100% funded ratio, and subsequent higher-than-average returns push the ratio to 110% or 120%, political pressure could arise to distribute the so-called "excess" funding by increasing benefits or decreasing contributions, potentially incurring new liabilities. There is also the issue of irrevocability of assets in an OPEB trust that could prove nettlesome to undo. Under GASB 45, only irrevocable trusts qualify for favorable accounting treatment.

To the extent that an OPEB trust becomes over funded, the government's ability to reclaim surplus assets may be impeded. Health care costs could also prove to be politically damaging to an OPEB funding strategy. As previously discussed, health care costs could rise or fall faster than expected causing the re-emergence of a significant UAAL or over funding, creating political pressure to re-examine the funding strategy. Indeed, to the extent health care costs are lower or higher than expected, due either to inaccurate inflation rates, a national health care plan or otherwise, the government's liability can dramatically increase or decrease. This begs the question of whether to issue OPEBOBs to fund the full UAAL, or only a portion of it to avoid future political problems.

Legal authorization

In most states, OPEB obligations are established through collective bargaining agreements between an employer and a union and are considered contractual obligations under the law. As such, there is a legal basis for delivering the promised benefits. The OPEBOBs issued to date were in California, Michigan, and Florida. These OPEBOBs were secured by GO or general fund pledges and the states granted OPEBOB issuers legal authority to issue the bonds. In California, the bonds went through further validation proceedings in the courts.

New state legislation and/or voter approval may be required to authorize bonds to pay OPEB liabilities. However, in other states where POBs issued as GO previously received voter approval, there is at least a precedent for the citizen assent of OPEB liability bond financing. Some employers could also have the option to use appropriation debt to fund OPEB obligations, or develop a new security for this purpose.

Once bonds are issued, employers must administer health benefits under a qualified legal framework approved by the IRS. Some issuers have established 501(c) and Voluntary Employee's Beneficiary Association (VEBA) trusts with a board comprising employees. Issuers could also establish a trust under the IRS Code Section 115, which functions like a pension trust fund and does not require a board. In addition, issuers with pension boards can establish a 401 (h) account, which is typically set up as an adjunct to an existing pension fund.

The rating process

Rating OPEBOBs parallels that of long-term debt with similar security and certain additional analytical factors pertinent to the OPEBOB and trust fund. Like POBs, the OPEBOBs issued to date have a GO or general fund pledge. In our specific analysis of OPEBOBs, we focus on the bonds' effect on the issuer's debt structure and the ability to meet obligations. The financial review includes the impact on both the balance sheet and the operating statement or cash flows. The status of the issuer's OPEB

trust fund on a pro forma basis is also part of the review as with any similar analysis. From the balance sheet perspective, we look at how the OPEBOB fits into the issuer's total capital improvement plan. We look at total debt with and without the OPEBOB so as not to penalize an issuer in comparison to another issuer that may have relatively low debt (and no OPEBOBs) but sizable unfunded liabilities. We also evaluate the leverage added by the OPEBOB:

- Does it markedly increase hard, fixed costs (bond debt service) in place of a softer, more discretionary obligation (health care and/or pension contributions), especially since most OPEBOBs will be taxable?

- If sub par investment returns put upward pressure on contribution rates, will they, coupled with the new higher debt service costs due to the OPEBOB, put the issuer's budget under greater strain?

The issuer must also be cognizant of the effect issuing an OPEBOB may have on statutory debt limits or whether the issuance impedes debt issuance for the capital improvement plan.

From a cash flow standpoint, we review projected debt service and contribution costs, with and without the POB, and the validity of the assumptions, including those for OPEBOB interest costs and trust fund investment returns to determine how these projections compare in total and annually.

The spread between interest costs and investment return generates the savings expected from the transaction:

- What is the magnitude of annual savings and total present value savings?

- Where (in what years) are the savings taken?

- Are the savings front-loaded in an attempt to mask budgetary stress?

- Will any front-loading lead to higher, unsustainable contribution rates in later years?

- Do the potential savings from the OPEBOB outweigh the risks involved?
- The cash flow analysis is a critical component to understanding the full impact of the transaction. As part of the OPEBOB analysis, we also review the status of the trust fund, which receives the bond proceeds:
- What is the statutory relationship between the issuer/employer and fund?
- How have the laws and precedents for contributing affected funding progress, and how do they play into the OPEBOB strategy?
- What are the funding goals and how will the OPEBOB affect these objectives?

In addition, OPEBOBs often require documentation that is not usually requested for other types of ratings:

Additional rating documentation For OPEBOBs

- OPEBOB financing plan, including its effect on the overall capital improvement plan.
- Projections of UAAL contributions and debt service with and without the OPEBOB.
- The most recent actuarial valuation and any experience studies of the OPEB trust fund; and
- Asset allocation strategy and plan for overseeing and investing OPEBOB proceeds.

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