The Truth about the State of Hawaii’s Employees’ Retirement System

The Hawaii Employees’ Retirement System (ERS) was established in 1926 to provide a core benefit to use in attracting and retaining employees needed to fulfill critical government duties. The ERS has provided career employees with modest, but meaningful, retirement benefits through a defined benefit pension plan. ERS covers more than 65,000 active employees and currently provides benefits to over 35,000 retirees and beneficiaries. ERS participants include the employees of the State of Hawaii, county employees and other participating public agencies.

Benefit Levels and Eligibility

There are now three tiers of benefits in the ERS for general employees:
- Contributory plan – hires before July 1, 1984. Contributions are 7.8 percent of pay.
- Non-Contributory plan – most hires between July 1, 1984 and July 1, 2006
- Hybrid plan – general employees hired on or after July 1, 2006. Contributions are 6.0 percent of pay.

An employee becomes “vested” or has the right, after satisfying a minimum service requirement, to ultimately receive a pension benefit regardless of whether the employee remains a member of the pension plan, after five years in the contributory and hybrid plans or ten years in the non-contributory plan. According to the Wisconsin Legislative Council’s 2008 Comparative Study of Major Public Employee Retirement Systems, nearly three-quarters of the public plans surveyed require five or fewer years of service to vest. Private sector plans typically provide vesting after five years.

Employees can typically retire at age 62 with 5 years or after 30 years of service and reaching age 55, whichever is earlier (contributory plan participants contributing 7.8 percent of pay can retire at age 55 with at least 5 years of service). This requirement is in line with other public
sector plans. In fact, because many public sector jobs are physically or emotionally demanding and employees who hold those positions are directly responsible for public safety and health, many such plans provide that employees can retire once the sum of their age and service equals 80.

For retirees who received benefits from ERS in 2008, the average annual benefit was $21,888, see page 115, ERS FY 2008 CAFR. As part of the formula used in calculating benefits, plans like ERS use a service credit multiplier. For most employees, ERS uses a service credit multiplier of either 1.25 percent (non-contributory plan), or 2.0 percent (contributory and hybrid plans). For example, the benefit for a hypothetical 20-year ERS participant with a final average salary of $40,000 would be calculated in the following manner:

If contributory:
$40,000 \times 20 \text{ years of service} \times \text{service credit multiplier of 2.0\%} = $16,000

If non-contributory:
$40,000 \times 20 \text{ years of service} \times \text{service credit multiplier of 1.25\%} = $10,000

Because an employee’s benefit can be calculated using a formula based on a percentage of final average pay and years of service, employers can efficiently manage the workforce. For example, 401(k) plan participants may invest too little, or their investments may provide insufficient returns, thus preventing employees from retiring and causing some employees to remain on the job even when their ability to perform job duties is declining. This can complicate the employer’s role, forcing decisions with unpleasant consequences for everyone.

Funding Sources

Revenues used to pay benefits come from three sources: employee contributions, employer contributions, and returns on investments. Because ERS, like all healthy public sector pension plans, receives the bulk of its revenues in the form of investment returns, the normal cost (the cost of benefits earned in the current year) is a reasonable 12.54 percent of payroll in 2008. The normal cost is borne by both the employer, which pays about 5.9 percent of payroll, and employees who pay 6.64 percent of each paycheck.

Contributions to the plan have generally been made according to schedule in recent years. However, funding the plan on a long-term basis requires leaving the excess investment returns in
the plan – to offset the losses in years when the markets struggle. The state has a history of raiding excess returns in good times. According to the ERS’ February 2010 newsletter:

“It was the diversion of over $1.6 billion in ERS’ excess investment returns since the 1960s that increased the unfunded liability and prevented the ERS from establishing a reserve to weather the years of poor investment returns, like the 2000-2002 and recent bear markets.”

If those funds had not been raided, and allowed to grow with interest, the ERS would have been in far better shape today. Fortunately, the newsletter also states that the Legislature and Administration stopped the practice of diverting excess investment earnings in 2005, and the Hawaii State Supreme Court ruled the practice in violation of the Hawaii Constitution. Preventing this practice is of the utmost importance in allowing excess investment returns to offset investment losses and allow for a long-term funding strategy to succeed.

ERS is Financially Sound

There have been some recent claims that public employee retirement systems across the country are facing a financial crisis. These claims are rarely true, and they are not true of ERS. As of June 30, 2008 ERS held net assets of more than $11.4 billion. Based on the actuarial value of those assets, at that time ERS had a funded ratio of 68.8 percent. (Recent surveys show that the average funding level for large public sector plans is in the range of 70 to 75 percent.) Most experts recommend a pension plan maintain a funding ratio of 80 percent or higher.

A plan’s funding ratio is simply a comparison of assets to accrued pension obligations. A retirement system’s liabilities are amortized over time – similar to paying off a mortgage. And, if investment results bounce back from the recent sharp decline – that will help payoff the unfunded obligations. In other words, a plan’s funding status is a snapshot that captures a government’s ongoing effort at one point in time to fund its future pension liability. If a state is consistently making its annual required contribution, its pension plan can have a funded ratio below 100 percent yet still be on track toward full actuarial funding.
A recent National Association of State Retirement Administrators report points out that Hawaii governments spent just 3.7 percent of their budgets on pension contributions in FY 2008. (Issue Brief: State and Local Government Spending on Public Employee Retirement Systems, National Association of State Retirement Administrators, January 2011). Due to the recent investment losses, contributions are expected to increase to up to 5 percent nationally.

It should come as no surprise that the 2008 market downturn adversely impacted all investors. What is surprising is that some individuals fail to account for the fact that defined benefit plan funding is structured to be carried out indefinitely. ERS is designed for the long haul and does not have an investment horizon like defined contribution savings plans that cover individual employees.

Defined benefit plans like ERS have access to professional investment managers who are trained in developing ongoing, long-term investment strategies that include an optimum mix of growth potential and risk. Participants and taxpayers benefit from the favorable investment performance of pooled pension fund assets. The wide range of investment options open to large pension plans, such as foreign and domestic stocks and bonds, real estate, and venture capital, also improve investment returns. Furthermore, ERS' investments are not affected by the retirement timing of a particular employee so the investment horizon never has to be shortened.

Current funding of DB plans actually reduces long-term costs over time through the compounding of contributions and interest earnings. To a large extent, investment returns dictate the level of contributions needed to keep pension plans funded at healthy levels because those returns provide about two-thirds of plan revenues which provide retirement benefits. Actuarial projections assume that over the long-term, ERS will earn eight percent each year on its investments. In some years returns will be below that rate and in others returns will exceed it. Over the most recent 5 years for which data is available, ERS has successfully outperformed its eight percent target, with an average annual return of 10.12 percent from 2002 through 2008, see page 72, FY 2009 CAFR. Although this is the most recent audited data available, it does not include the significant loss in asset values during the first three quarters of fiscal year 2009. While it is likely the fund’s performance over the past fifteen months will show a substantial recovery,
Hawaii’s pension fund, like all personal savings and pension assets invested in equities, have not fully rebounded.

When returns are strong and above the actuarial assumed rate, as they have been in 4 of the past 5 years for which audited data is available, the employer’s level of contributions will generally be lower than when investment returns lag the actuarially assumed rate. When returns are less than projected, those actuarial losses are amortized through increased employer contributions, which is one reason why contributions needed from the employer will increase over the levels needed earlier in the decade.

Plan investments not only benefit plan participants, but are also a critical part of the economic fabric of the state, creating thousands of jobs. According to the National Institute on Retirement Security (NIRS), each dollar in taxpayer contributions to Hawaii’s ERS pension plan supports $5.17 in long-term economic activity in the state. This reflects the fact that taxpayer contributions are a minor source of financing for retirement benefits that ultimately provide income and jobs for others. NIRS estimates that retiree expenditures stemming from state and local pension plan benefits support over 6,300 jobs in the state and the total income to state residents supported by pension expenditures was $372.3 million, “Pensionomics: Measuring the Economic Impact of State and Local Pension Plans,” National Institute on Retirement Security, February 2009.

AFSCME believes in a society of opportunity; where all workers not only earn a living wage and can afford to see a doctor when they are sick, but where we all have the opportunity to reach our full potential in our chosen careers and where we all have the opportunity to retire with dignity when our work is done. For decades ERS has provided workers and their beneficiaries with secure retirement benefits and there is no reason to believe it will not continue to be able to do so.