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SUBJECT: Management Advisory – Federal Employees Retirement System
Overfunding (Report Number FT-MA-10-001)

This report presents the results of our review of the Federal Employees Retirement System (FERS) projected fund surplus as of September 30, 2009 (Project Number 10BS001FT000).¹ The objective was to review the methodology for funding the FERS pension responsibility and determine if there are opportunities for the U.S. Postal Service to use the surplus to address its current and future financial situation. This self-initiated review addresses financial risk. See [Appendix A](#) for additional information about this review.

This report is one in a series of reports that describes the unsettling trend of the Postal Service paying more than its fair share of retiree benefit payments owed to the federal government. In a recent U.S. Postal Service Office of Inspector General (OIG) report, we disclosed the inequitable funding of the Civil Service Retirement System (CSRS), which resulted in the Postal Service overpaying an additional \$75 billion into the pension fund.² This followed two other instances of overfunding CSRS pension obligations.³ In addition, the OIG also reported that an exaggerated 7 percent health care inflation forecast (instead of the 5 percent industry standard) resulted in an overpayment of \$13.2 billion for retiree health care liabilities.⁴ In response, Congress urged the Postal Service to coordinate with the OPM and the Office of Management and Budget to develop “a fiscally responsible legislative proposal” for Postal Service benefit payments. We will be following this report with another report that evaluates the

¹ FERS is one component of the Civil Service Retirement and Disability Fund (CSRDF).

² *The Postal Service’s Share of CSRS Pension Responsibility* (Report Number RARC-WP-10-001, dated January 20, 2010).

³ In 2002, the Office of Personnel Management (OPM) found the Postal Service overfunded its CSRS obligations by \$78 billion. Legislation in 2003 corrected this overfunding. It was later determined the Postal Service was overcharged \$27 billion for CSRS military service credits. In 2006, these funds were returned to the Postal Service, which used the surplus to fund retiree health care liabilities.

⁴ *Estimates of Postal Service Liability for Retiree Health Care Benefits* (Report Number ESS-MA-09-001(R), dated July 22, 2009).

prefunding requirements and benchmarks against other large companies and the federal government.

The Postal Service's pension obligations include both CSRS and FERS. As discussed, the problems noted in the past have focused on CSRS and military pension liabilities and retiree health benefit obligations. However, at the end of fiscal year (FY) 2009, the OPM projected a \$6.8 billion surplus in the FERS portion of the CSRDF.

Conclusion

The Postal Service has opportunities to use at least \$5.5 billion⁵ of the \$6.8 billion in FERS surplus funds to address its current and future financial condition. We found the Postal Service continues to overfund its retirement obligations and there is no present legislation to resolve surpluses. Further, it is vital that the Postal Service's responsibilities be clearly delineated and separated from those of the rest of the federal government. The overcharges associated with CSRS obligations, coupled with the FERS surplus discussed in this report, have adversely affected the Postal Service's financial position, hindered its ability to operate efficiently in a business-like matter, and hindered its transformation under the Postal Accountability and Enhancement Act (PAEA).⁶ Action is needed to prevent a repeat of historical trends in the overfunding of Postal Service retiree benefits.

Although we did not review the current actuarial valuation of the FERS pension liability,⁷ we did find that known or future changes to the valuation will impact funding of the FERS pension. Management will need to consider these factors when determining what action is needed to address the FERS surplus.

FERS Surplus

Consistent with other retiree benefit obligations, the Postal Service is being unfairly burdened for its share of the FERS pension obligation. The OPM projected a \$6.8 billion surplus in the Postal Service's FERS obligation at the end of FY 2009. The OPM acknowledged that the federal government's FERS obligation, excluding the Postal Service, was unfunded by \$7.4 billion at the end of FY 2008.⁸ The funding status for the Postal Service, as well as the federal government, is calculated by subtracting

⁵ Projected overfunded amount as of September 30, 2009 (\$6.8 billion), less the impact of the 30-year anticipated liability for sick leave credit (\$680 million), less the impact of potential changes to actuarial assumptions (\$620 million).

⁶ Public Law 109-435.

⁷ In accordance with PAEA, the OPM is responsible for calculating and providing pension obligation data.

⁸ The OPM has not yet determined the actual amount for the Postal Service and the rest of the federal government as of the end of FY 2009. The Postal Service's overfunded amount at the end of FY 2008 was \$6.5 billion. According to the OPM, the federal government is currently paying a supplemental liability amortized over 30 years to fully fund FERS.

the pension assets⁹ from the actuarial accrued liability.¹⁰ A higher liability results in an unfunded status, while a lower liability results in a surplus. According to the OPM, the liability is a projection for current and future benefit obligations and considers contributions paid into and disbursements from FERS. Overall, the liability is based on estimated demographics for the entire federal government, including the Postal Service. However, the Postal Service's benefits paid represent actual demographic behavior, such as early career turnover, and not the aggregate, resulting in a surplus status for the Postal Service and an unfunded status for the federal government.

Based on this data, the Postal Service's overfunding issue is even larger than we previously reported. Similar to what we have noted in other OIG retiree benefit reports, Postal Service ratepayers continue to pay more than their fair share of retiree benefits. It is important that the trend of overpayments does not continue. The Postal Service faces a challenging future and its responsibilities and the true cost of funding postal operations needs to be absolutely clear. To address that challenge, the Postal Service is making operational changes to bring costs in line with revenue projections. Additionally, it is pursuing legislative changes to address concerns raised about pension and retiree health benefit payments. We believe management should also consider the FERS overfunding issue as the Postal Service pursues legislative changes.

Legislative Actions

Current legislation¹¹ does not specify how to resolve a surplus in the CSRDF. The Postal Service is required to pay the normal cost¹² annually, plus a supplemental amount if the fund has an unfunded liability as of the measurement date (September 30). If the fund has a surplus, there is no process to reduce the normal cost contributions.

Further, legislation does not address how to consider future refinements in the liability calculation and variances from actuarial gains that have a direct effect on the funding status. Refinements, such as FERS credit for sick leave, mortality expectations, and actuarial assumptions used, are important to consider when determining what should be done with the surplus and future FERS pension obligations.

⁹ Pension assets are used to pay retirement benefits and are comprised of investments, accrued interest on those investments, and contributions by employers and participants.

¹⁰ Actuarial accrued liability is defined as the actuarial present value of future benefits less the present value of future normal cost contributions. The actuarial present value of future benefits is the value of plan benefits that are expected to be paid in the future to current employees and annuitants stated in today's dollars. The present value of future normal cost contributions is the value, in today's dollars, of the future normal cost contributions to be made over the expected future working lifetimes of all current employees.

¹¹ U.S. Code, Title 5, Part III, Subpart G, Chapter 84, Subchapter II, § 8423 (b) (1) through (5).

¹² A plan's target normal cost is the present value of all benefits expected to be earned under the plan during the plan year.

- [Sick Leave Credit](#)

Legislation¹³ was passed providing a retirement credit for sick leave. Eligible FERS employees will receive a length-of-service credit for their sick leave balances. The Congressional Budget Office estimated this will add an average of 3 months to employees' length of service. It would boost the average retirement benefit for an individual by \$150 per year and \$343 million for FYs 2010-2019 for the whole federal government. Both estimates include the Postal Service and its employees.

The Hay Group¹⁴ estimates that it is likely that Postal Service FERS employees will take advantage of this benefit and their behavior will mirror that of CSRS employees (who currently have this benefit). This 30-year anticipated liability could reduce the current plan surplus by up to \$680 million.

- [Mortality Expectations](#)

Because employees and annuitants are expected to live longer, the OPM's Board of Actuaries incorporated an assumption of future mortality improvement into the actuarial valuation as of September 30, 2007. This will cause the Postal Service's (and the rest of the federal government's) contribution rate to increase from 11.2 to 11.5 percent (employee's payroll deductions remained unchanged), effective in FY 2011. The FERS surplus currently associated with the Postal Service may make it inappropriate for the agency to contribute at the same rate as the rest of the federal government.

- [Actuarial Assumptions](#)

The OPM uses actuarial assumptions for the future rate of inflation, cost-of-living adjustments, annual salary increases, and a projected rate of return on the CSRDF to establish contribution rates. Understandably, actuarial assumptions will never equal the actual experiences, resulting in actuarial gains or losses. Changes in the economic climate or demographics may alter the funding status.

The surplus is very sensitive to assumptions in the rate of return on the fund. However, this rate of return is likely to rise and fall consistently with the rate of inflation, and payments out of the fund would be somewhat sensitive to these inflationary pressures. The net effect of the volatility of these assumptions would likely reduce the surplus by \$620 million.

¹³ H.R. 2647, *National Defense Authorization Act for Fiscal Year 2010*, October 22, 2009.

¹⁴ A consulting firm that specializes in retirement benefits who we contacted to estimate the impact that the sick leave credit and actuarial assumptions factors have on the FERS portion of the CSRDF.

The Postal Service was intended to be an independent, self-sufficient entity. As discussed in previous reports, during the period when postal rates were set to cover costs, citizens and businesses were charged far in excess of what was needed to fund benefits. Postal Service ratepayers should not be burdened with federal liabilities. Instead, they should be credited for their previous overpayments. Resolving the surplus issue could assist the Postal Service with regaining financial strength and align it with private sector funding for pension funds.

Separate Fund

Having retirement expenses commingled with the federal government's budget, while being expected to operate as an efficient business, puts the Postal Service in a precarious position. The surplus in the CSRDF effectively subsidizes appropriated tax dollars when it could be used to offset the Postal Service's current and future business expenses.

In addition, the PAEA requires the Postal Service to make certain disclosures regarding obligations and changes in net assets as if the funds were separate. The OPM must provide annual projections to the Postal Service for the retirement programs. Although the Postal Service reports this required information in its annual 10-K financial report, by having the OPM establish a sub-account within the CSRDF (without requiring legislation), the sub-account would provide a more accurate reflection of the Postal Service's retirement fund status and increase transparency.

The FERS surplus indicates that the Postal Service has paid more than it needs to in order to cover those retiree benefits. However, there is a potential risk that the Postal Service's liability may increase once a sub-account is established. Regardless, the Postal Service would correctly align its pension obligations with its business revenue and contribute what is necessary for its retirement expenses.

Impact of Resolving Overfunding

The Postal Service's financial outlook has deteriorated significantly in recent years. The Postal Service finished FY 2009 with a \$3.8 billion loss. It also projects a \$7 billion loss for FY 2010 and continues to project losses through 2020. The current and projected losses present a serious financial challenge to Postal Service management. Controlling excessive surpluses in FERS pension obligations would substantially reduce annual expenses the Postal Service incurs and increase the cash flow from its operations. This promotes the Postal Service's ability to operate on a self-supporting, break-even basis and cover its expenses through its revenues rather than taxpayers dollars.

Based on our analysis, we have determined that the projected \$6.8 billion surplus, considering the impact of sick leave credit and potential changes to the actuarial

assumptions, results in a \$5.5 billion adjusted surplus.¹⁵ See [Appendix B](#) for the Hay Group's *Report on the United States Postal Service Federal Employees' Retirement System*. We believe the Postal Service should pursue legislative action to use the FERS surplus to its financial benefit and navigate toward a profitable future.

We recommend the vice president, Government Relations and Public Policy, in coordination with the chief financial officer and executive vice president:

1. Pursue legislative action to alter the Postal Service's Civil Service Retirement and Disability Fund contributions for 1 or more years until the Federal Employees Retirement System surplus is extinguished.
2. Coordinate with the Office of Personnel Management to identify causes of actual payout differences between the Postal Service and the rest of the federal government and use that information to reduce the risk of future surpluses.
3. Pursue legislative action to define future distribution of significant surpluses.
4. Coordinate with the Office of Personnel Management to create a sub-account within the Civil Service Retirement and Disability Fund exclusive to the Postal Service.

Management's Comments

Management agreed with our finding and recommendations and stated that legislative change should be pursued if FY 2010 FERS valuations support it. Since the FERS overfunding issue is relatively new, management believes a comprehensive educational effort to inform Congress of this development is necessary. Management also noted they will coordinate with the OPM to identify differences between pension benefit payments for the Postal Service and the rest of the federal government and to create a Postal Service sub-account within the CSRDF. Finally, they will pursue legislative amendments to define future distribution of significant surpluses. See [Appendix C](#) for management's comments in their entirety.

In subsequent correspondence, management targeted resolution of these issues by September 30, 2011.

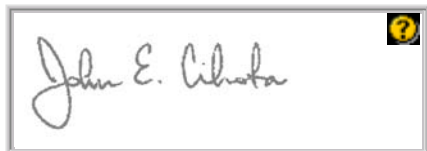
¹⁵ Projected overfunded amount as of September 30, 2009 (\$6.8 billion), less the impact of the 30-year anticipated liability for sick leave credit (\$680 million), less the impact of potential changes to actuarial assumptions (\$620 million).

Evaluation of Management's Comments

The OIG considers management's comments responsive to the recommendations and management's corrective actions should resolve the issues identified in the report.

The OIG considers all the recommendations significant, and therefore requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective actions are completed. These recommendations should not be closed in the Postal Service's follow-up tracking system until the OIG provides written confirmation that the recommendations can be closed.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Lorie Nelson, director, Financial Reporting, or me at 703-248-2100.

A rectangular box containing a handwritten signature in cursive that reads "John E. Cihota". In the top right corner of the box, there is a small yellow question mark icon.

John E. Cihota
Deputy Assistant Inspector General
for Financial Accountability

Attachments

cc: Vincent H. DeVito, Jr.
Deborah Giannoni-Jackson
Stephen J. Masse
Corporate Audit Response Management

APPENDIX A: ADDITIONAL INFORMATION

BACKGROUND

Postal Service employees participate in one of three¹⁶ retirement programs based on the starting date of their employment with the federal government. Career employees hired after December 31, 1983, generally participate in FERS, which provides the same retirement benefits as other federal government employees. FERS consists of three elements: Social Security, a FERS annuity, and the Thrift Savings Plan. This review focused only on the FERS annuity.

The CSRDF is available to pay both CSRS and FERS benefits. The OPM administers the CSRDF and distributes annuities to retirees. The Postal Service contributes to the CSRDF under provisions of the law through its business revenue and not through appropriated tax dollars, as most federal agencies are funded. PAEA requires the Postal Service to make certain disclosures regarding obligations and changes in net assets as if the funds were separate. We took information regarding the CSRDF from assumptions the OPM provided to the Postal Service for its annual 10-K report. This review focused on the FERS portion of the fund.

At the end of FY 2009, approximately 507,000 career employees (81 percent of all Postal Service employees) were enrolled in FERS. The Postal Service contributed \$3 billion to CSRDF for FERS based on a contribution rate of 11.2 percent of basic pay for most employees. The OPM establishes FERS contribution rates using actuarial assumptions for future rates of inflation, cost-of-living adjustments, annual salary increases, and an assumed rate of return on the CSRDF. Federal agencies, including the Postal Service, are required to fully fund FERS pension costs. This is done through contributions from the various agencies along with employee payroll deductions.

At the end of FY 2008, the Postal Service's portion of FERS had a \$6.5 billion surplus based on information from the OPM. The FERS surplus was projected to be \$6.8 billion at the end of FY 2009.¹⁷ The OPM projected a \$6.8 billion surplus in the Postal Service's FERS obligation at the end of FY 2009. The OPM acknowledged that the federal government's FERS obligation, excluding the Postal Service, was unfunded by \$7.4 billion at the end of FY 2008.¹⁸ As of September 30, 2009, the federal government's and the Postal Service's share of the CSRDF (including both FERS and CSRS) was 41 and 99 percent funded, respectively. As a whole (including both the federal government and Postal Service), CSRDF (including both FERS and CSRS) was 52 percent funded.

¹⁶ The three retirement programs are CSRS, Dual CSRS/Social Security, and FERS.

¹⁷ The OPM has not yet determined the final FY 2009 funding status.

¹⁸ The OPM has not yet determined the actual amount for the Postal Service and the rest of the federal government as of the end of FY 2009. The Postal Service's overfunded amount at the end of FY 2008 was \$6.5 billion. According to the OPM, the federal government is currently paying a supplemental liability amortized over 30 years to fully fund FERS.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to review the method for funding the FERS pension responsibility and determine if there are opportunities for the Postal Service to use the FERS surplus to address its current and future financial situation. To achieve our objective, we:

- Reviewed prior OIG and Government Accountability Office (GAO) reports.
- Researched financial reports from Watson Wyatt,¹⁹ the OPM, and other governmental entities.
- Studied FERS legislation.
- Calculated the Postal Service's contributions to FERS.
- Solicited input from the OPM, the GAO, the Postal Regulatory Commission, and the Postal Service.
- Evaluated impacts and potential change in the FERS portion of the CSRDF pension fund valuation.²⁰

We conducted this review from March through August 2010 in accordance with the *Quality Standards for Inspections*.²¹ We discussed our observations and conclusions with management officials on June 22 and 25, 2010, and included their comments where appropriate.

We determined the computer-generated data from the Postal Service's Accounting Data Mart to be reliable. To validate the data, we reconciled account balances to supporting reports to ensure accuracy. We did not independently verify the \$6.8 billion surplus or the OPM's actuarial assumptions and contribution rate. The procedures we performed do not constitute an audit or an actuarial review of the OPM's projections, and we are not expressing an opinion on the material accuracy of the calculations made by the OPM.

PRIOR AUDIT COVERAGE

- *The Postal Service's Share of CSRS Pension Responsibility* (Report Number RARC-WP-10-001, dated January 20, 2010). This white paper addressed the

¹⁹ Watson Wyatt (Towers Watson) is a leading global professional services company that helps organizations improve performance through effective people, risk, and financial management.

²⁰ We contracted with the Hay Group, a consulting firm specializing in retirement benefits, to perform the evaluation.

²¹ These standards were last promulgated by the President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE) in January 2005. Since then, The Inspector General (IG) Act of 1978, as amended by the IG Reform Act of 2008, created the Council of the Inspectors General on Integrity and Efficiency (CIGIE), which combined the PCIE and ECIE. To date, the *Quality Standards for Inspections* have not been amended to reflect adoption by the CIGIE and, as a result, still reference the PCIE and ECIE.

inequitable funding of CSRS, which resulted in the Postal Service overpaying \$75 billion into the pension fund. We suggested the surplus be transferred to the Postal Service Retiree Health Benefit Fund to fully meet the Postal Service's future retiree health care liability and eliminate the need for future annual payments. Additionally, the payments for current retiree health benefits could be drawn from the fund, saving the annual cost (which was \$2 billion in FY 2009).

- *Federal Budget Treatment of the Postal Service* (Report Number ESS-WP-09-001, dated August 27, 2009). This white paper disclosed that, with regard to the federal budget, the Postal Service's revenue and expenses are classified as off-budget, yet the retirement contributions are classified as on-budget and included in the budget process. Reductions in retirement contributions have a negative effect on the federal deficit, which are disadvantageous to the federal government. To foster Postal Service independence, we suggested that the Postal Service pursue legislative change to shift its retirement fund to off-budget status.
- *Estimates of Postal Service Liability for Retiree Health Care Benefits* (Report Number ESS-MA-09-001(R), dated July 22, 2009). This report concluded that the OPM's actuarial assumption for the annual health care cost inflation rate was unreasonably high, which resulted in overestimating the Postal Service's future retiree health care liability by \$13.2 billion by the end of FY 2016. We recommended the Postal Service pursue legislative relief from the mandated schedule of payments into the Postal Service Retiree Health Benefit Fund.
- *Civil Service Retirement System Overpayment by the Postal Service* (Report Number CI-MA-10-001, dated June 18, 2010). This report concluded that the return of the overpayment or a combination of actions to realize the benefit of the \$75 billion overpayment to the Postal Service would fully fund the pension and health retiree plans. Also, the Postal Service's more than \$7 billion annual payments for retiree health care prefunding and retiree health care premiums would no longer be needed because (1) the pension and health care retiree plans would be fully funded and (2) interest income from the fully funded retiree health benefit fund could pay annual premiums. We recommended the Postal Service secure the return of the \$75 billion overpayment or to otherwise realize the benefit of this overpayment to the Postal Service.

[APPENDIX B: HAYGROUP REPORT](#)



**Report on the
United States Postal Service
Federal Employees' Retirement System**

April 20, 2010



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I. Executive Summary

In light of the new service credit opportunity resulting from the provisions in the National Defense Authorization Act of 2010, it is likely that FERS-covered employees will accumulate additional unused sick leave in order to receive these benefits. Further, employees with significant unused sick leave balances may delay their retirement until after 2013 in order to receive full credit for the sick leave balance.

As this credit structure is already available to CSRS employees, the sick leave accumulation behavior of CSRS employees has been used in our analysis as a predictor of future behavior by FERS employees. As shown in Section II, this model predicts that over time, FERS employees will build up significant unused sick leave balances, and accordingly the additional benefits to be provided by the FERS plan will reduce the current plan surplus by up to \$680 million.

This is a 1 percent increase in the liability of the plan, representing a decrease of approximately 10.5% of the current surplus.

Separately, we analyzed the potential change in liability from a change in the valuation assumptions. Historically, OPM has updated the valuation assumptions periodically, usually every five years. Over the last few years inflation has been lower than assumed and the rate of return on the investments has also declined. We evaluated the impact of a 50 basis point reduction in inflation and corresponding reduction in assumed salary increases and investment returns. As shown in Section III, modifying the assumptions to reflect lower inflationary expectations would likely result in a reduction of the current surplus of \$620 million.

This represents less than a 1 percent increase in the liability of the plan, representing a decrease of approximately 10 percent of the current surplus.

If the only assumption that is modified is the discount rate, then this would lead to an increase in liability of almost \$6 billion, resulting in a reduction of 90 percent of the current surplus.

These financial impacts were developed independently. The financial impact of both the sick leave accrual and the change in valuation assumptions can be modeled by adding together the individual results.



II. Analysis of Change in Sick Leave Usage on USPS Federal Employees Retirement System (FERS)

Introduction

The National Defense Authorization Act of 2010, enacted on October 28, 2009, includes provisions allowing postal and federal workers retiring under the Federal Employees Retirement System (FERS) to receive additional service credit for unused sick leave.

Previously, only CSRS members receive additional service credit for unused sick leave. The law change now aligns (when fully phased-in) the sick leave rules and creates an incentive for FERS members to use their sick leave for the purpose for which it was intended – with an incentive to accrue unused sick leave towards retirement income.

The Office of Inspector General on the United States Postal Service (USPS-OIG) has requested that Hay Group prepare an estimate of the impact of the change in sick leave rules on the FERS Postal Fund.

There is a phase-in of the service credits over the next several years. Specifically, from October 28, 2009 through December 31, 2013, retiring FERS-covered employees can convert 50% of their unused sick leave at retirement into additional months of pensionable service time for the purpose of calculating their FERS annuity. FERS employees retiring on or after January 1, 2014 can convert all of their unused sick leave at the time of retirement in the calculation of their FERS annuity.

Other than the 50% limitation applicable between now and December 31, 2013, there is no limit as to how much sick leave will be used in the annuity calculation. Unused sick leave (as well as unused annual leave) credit cannot be used to calculate the retiring employee's high-three average salary.

Sick Leave Analysis

Hay Group received data from USPS on sick leave usage during the four years before retirement for an analysis of the usage patterns of retiring employees for another study Hay Group performed for the Postal Service. With the permission of the Postal Service, we used the same data for this study.

Sick leave is earned in hours. A full time employee normally accrues four hours of sick leave for each pay period. For sick leave conversion credit, unused sick leave hours are



converted to months and years on the basis of a 2087 hour work year and 360 days in a year. Appendix A contains the conversion chart prepared by OPM.

The data covered 2004 through 2007 usage for employees who retired in 2007 and also covered 2003 through 2006 usage for employees who retired in 2006. The data were provided separately for CSRS employees, Dual CSRS employees and FERS employees.

We analyzed the data for sick leave balance and usage in the year of retirement and each of the three years prior to retirement. In general, the analysis showed that when employees were approaching retirement, they stopped accruing the sick leave balance (that is, the usage was higher than the sick leave earned for the year). This pattern was visible for both CSRS and FERS employees, as shown in Table II.1.

	CSRS		FERS	
	Balance	Used	Balance	Used
Last Year of Retirement	994	189	316	185
Retirement -1 Year	1,134	184	457	173
Retirement - 2 Year	1,218	107	531	114
Retirement -3 Year	1,224	90	544	99

The sick leave balances for CSRS employees are larger on average than those for FERS employees for two reasons. First, retiring CSRS employees have on average more years of service than retiring FERS employees. Second, retiring CSRS employees have an incentive to accrue additional hours of sick leave so that they can convert the unused paid time off into a higher pension benefit.

Since the law change we expect the FERS employees to accumulate more sick leave - with accrual patterns similar to CSRS employees. The following table shows the average sick leave balance in their year of retirement for CSRS and FERS retirees with between 20 to 30 years of service. There were too few CSRS retirees with fewer than 24 years of service to develop reliable averages. Table II.2 compares employees with similar lengths of service - so the difference between the sick leave balances can be attributed to the different incentives between CSRS and FERS.



Table II.2 Sick Leave Balance By Years of Service And Average Accrual Rate per Year of Service				
Service	CSRS Balance	CSRS Average Accrual Rate Per Year of Service	FERS Balance	FERS Average Accrual Rate Per Year of Service
20			370	0.9%
21			369	0.8%
22			375	0.8%
23			454	0.9%
24	749	1.5%	480	1.0%
25	695	1.3%	380	0.7%
26	687	1.3%	384	0.7%
27	741	1.3%	433	0.8%
28	723	1.2%	498	0.9%
29	809	1.3%	398	0.7%
30	799	1.3%	316	0.5%

If FERS employees were to accrue unused sick leave in a pattern similar to that exhibited by CSRS retirees, the FERS employees would accrue additional service credit of approximately 1.30% per year of service, resulting in a similar increase in the Actuarial Accrued Liability for future FERS retirees (1.30%).

Table II.3 shows the impact of the sick leave credit on the Accrued Liability, Normal Cost and Unfunded Liability under the three different sick leave accrual rates.

We estimate the increase in the Actuarial Accrued Liability recognizing the value of the additional benefits earned due to conversion of unused sick leave balances at retirement to be \$680 million. This estimate is based on FERS employees exhibiting the similar sick leave usage patterns evidenced by CSRS employees.



Table II.3
Impact on USPS FERS Surplus from
National Defense Authorization Act of 2010
(Conversion of Unused Sick Leave Balances into
Additional Pension Service)
Amounts in \$billions As of September 30, 2008

	Before Reflecting NDAA	Projected Results After Reflecting NDAA
Adjustment Factor for Future Retirees		1.30%
Present Value of Benefits as of		
Current Retirees	\$10.46	\$10.46
Future Retirees	92.14	93.34
Total	102.60	103.80
Present Value of Contributions	39.80	40.32
Actuarial Accrued Liability		
Current Retirees	\$10.46	\$10.46
Future Retirees	52.34	53.02
Total	62.80	63.48
Normal Cost	3.10	3.14
Postal FERS Fund as of 9/30/2008	69.30	69.30
Unfunded Liability (Surplus)	(6.50)	(5.82)

Table II.4 below shows the projected change in the surplus following remeasurement reflecting the additional actuarial accrued liability attributable to the service from conversion of sick leave balances at retirement.



Table II.4 Reduction in Surplus Due to National Defense Authorization Act of 2010 Amounts in \$millions	
Surplus before National Defense Authorization Act of 2010	\$6,500
Surplus after reflecting NDAA	\$5,820
Reduction in surplus	\$680



III. Analysis of Impact of Actuarial Assumptions on the USPS FERS Surplus

The Office of Personnel Management's Office of the Actuary published a valuation of the USPS Federal Employees Retirement System (FERS) as of September 30, 2008 and projected the Fund's financial position as of September 30, 2009. As of September 30, 2008, the Fund had a surplus of \$6.5 billion and is projected to have a surplus as of September 30, 2009 of \$6.8 billion.

Given the size of the surplus and the financial pressures the USPS is currently experiencing, the USPS OIG requested that Hay Group evaluate the size of the surplus and determine the likely impact on the surplus from possible changes to the actuarial assumptions used in the measurement.

We have therefore prepared in this report an analysis of the impact of possible changes in economic assumptions on the calculation of the FERS surplus. For consistency, we present our analysis in terms of changes in results of the most recent complete actuarial valuation, as of September 30, 2008 before reflecting the likely impact of the National Defense Authorization Act of 2010 which will permit retiring FERS employees to convert unused sick leave balances into additional months of credited service.

To provide context for these results, we also provide a summary of the most recent valuation results and a projection of results to September 30, 2009.

Our analysis presents two alternatives to the present valuation assumption set. In the first scenario, the only change is that the discount rate is reduced from 6.25% to 5.75%; this change would reduce the surplus by 90%, from \$6.5 billion to \$610 million. If however, the 50 basis point reduction in the discount rate is based on an expected reduction in the long-term rate of inflation, it would be appropriate to also reduce the CPI and salary scale assumptions by 50 basis points, and this is shown in scenario 2. These changes to the assumption set results in a 10% reduction in the surplus, from \$6.5 billion to \$5.88 billion.

In our projection of current valuation results to September 30, 2009, based on the limited experience information currently available, the projected surplus increases 5%, from \$6.5 billion to \$6.8 billion. This suggests that, based on currently available information, the results of analysis as of September 30, 2009, will be similar to the results shown by the current analysis.



Impact of Assumption Changes on FERS Surplus

In Table III.1 below, the first column presents a summary of results from the most recent actuarial valuation of the FERS program, as of September 30, 2008.

Scenario 1 shows the effect of a change in the discount rate from 6.25% to 5.75%. Under scenario 1, no other changes to the assumptions are made. Scenario 2 shows the effect of a 50 basis point decrease in 3 assumptions (discount rate, CPI and salary scale), based on the standard process that actuaries use in developing assumptions, building on a base inflation assumption, then adding on to that for long-term salary increases and long-term real returns on investments.

Table III.1 Impact of Economic Assumptions on USPS FERS Surplus Amounts in \$billions as of September 30, 2008			
	Current	Scenario 1	Scenario 2
	Unadjusted Valuation Results	Discount Rate Change Only	Discount Rate, CPI and Salary Rate Change
A. Actuarial Assumptions			
1. Discount rate	6.25%	5.75%	5.75%
2. CPI	3.50%	3.50%	3.00%
3. Salary Growth Rate	4.25%	4.25%	3.75%
B. Present Value of Benefits			
1. Current Retirees	\$10.46	\$11.18	\$10.56
2. Future Retirees	92.14	105.48	93.06
3. Total	102.60	116.66	103.62
C. Present Value of Contributions	39.80	47.97	40.20
D. Actuarial Accrued Liability			
1. Current Retirees	10.46	11.18	10.56
2. Future Retirees	52.34	57.51	52.86
3. Total	62.80	68.69	63.42
E. Normal Cost	3.10	3.53	3.13
F. Postal FERS Fund	69.30	69.30	69.30
G. Unfunded Liability (Surplus)	(6.50)	(0.61)	(5.88)



IV. Commentary on Retirement System Funding Levels

The funding of the Federal Employees Retirement System is governed by Public Law. The law sets out an asymmetrical funding mechanism, whereby the Postal Service is required to pay the Normal Cost annually, plus a Supplemental amount if the fund has an unfunded liability as of the measurement date. The supplemental amount is set to amortize the unfunded liability over 30 years. If at a subsequent measurement date the fund no longer has an unfunded liability, the Supplemental amortization schedule is extinguished. The funding mechanism is asymmetrical in that if the fund has a surplus, the mechanism does not reduce the Normal Cost contributions.

Employees contribute 0.8 percent of payroll and USPS is required to pay the Normal Cost, currently 11.2 percent of payroll. Effective October 1, 2010, the USPS Normal Cost will increase to 11.5 percent of payroll. This rate was established before the National Defense Authorization Act of 2010 was enacted, so it is likely that the rate effective October 1, 2011 will increase to 11.6 or 11.7 percent of payroll to reflect the increase in liability.

At the request of the USPS OIG, we have set out recommended mechanisms that could be adopted to manage the funding level of FERS.

Option A – Amend the funding rules to make the contribution requirements symmetrical.

Option B – Establish a corridor around the full funded status and adjust the Normal Cost contributions if and only if the funded status is outside the corridor.

Under Option A, the current mechanism could be amended to add an offset to the Normal Cost if the fund has a surplus by amortizing the surplus over 30 years. This would make the funding system symmetrical and ensure small changes in funding occur annually taking into account emerging experience (both asset and liability experience). As FERS is an open system, an amortization period of 30 years is appropriate to ensure that funding is completed by the time employees reach retirement age. As the plan matures, it may be appropriate to shorten the amortization period to 20 or 25 years.

Under Option B, a corridor would be established, for example 10 percent, such that the required funding is just the Normal Cost whenever the measurement of the system shows that assets are within 90 to 110 percent of the fund's actuarial accrued liability. If the funded status is below 90 percent, then the funding would include an additional amortization payment to bring the system closer to 100 percent (fully funded).



Similarly, if the funded status is above 110 percent, the funding would include a negative amortization payment to bring the system closer to 100 percent (fully funded) position. There are several factors that should be considered with this option. The size of the corridor could be chosen to be narrow (e.g. 5 percent) or wide (e.g. 15 percent). Furthermore, the amortization period could be short (e.g. 10 years) or long (e.g. 30 years).



V. USPS FERS Valuation – Summary of Current Results and Projection of Surplus to September 30, 2009

In October 2009, OPM prepared the following actuarial valuation results with respect to USPS employees in the Federal Employees Retirement System.

Section 1 sets out the position based on the full liability – including costs for service rendered to date as well as expected future service. Of the total liability (present value of future pension benefits for all employees) of \$102.6 billion, \$39.8 billion is expected to be funded from future employee and employer contributions at the standard rates, leaving an Actuarial Accrued Liability balance of \$62.8 billion. As of September 30, 2008, the Postal FERS Fund was valued at \$69.3 billion, which is \$6.5 billion more than the Actuarial Accrued Liability. As a result, the Postal FERS Fund had a surplus of \$6.5 billion as of September 30, 2008.

1. FERS

Present Value of Benefits as of 9/30/2008	\$102.6 billion
- Present Value of Contributions	- 39.8
Actuarial Accrued Liability	62.8 billion
- Postal FERS Fund 9/30/2008	<u>- 69.3</u>
Unfunded Liability	\$ - 6.5 billion

Section 2 shows the progress of the Actuarial Accrued Liability from September 30, 2007 to September 30, 2008. During the year, the liability increased due to additional benefits being earned of \$3.1 billion, and decreased \$0.8 billion when benefits were paid. The passage of time increased the liability by \$3.6 billion and a re-measurement of the liability showed an actuarial loss of \$1.8 billion, resulting in the Actuarial Accrued Liability as of September 30, 2008 of \$62.8 billion.

2. Analysis of Pension Expense for Postal Service - FERS

Actuarial Liability as of 9/30/2007	\$ 55.1 billion
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+	Normal Cost Contributions during FY2008	+ 3.1
-	Benefits Paid during FY2008	- 0.8
+	Interest Expense during FY2008	+ 3.6
+	Actuarial Loss during FY2008	+ 1.8
	Actuarial Liability as of 9/30/2008	\$ 62.8 billion

For the valuation as of 9/30/2007, the FERS COLA for FY2009 was assumed to be 2.8%, but the actual COLA for FY2009, which was reflected in the valuation as of 9/30/2008, was 4.8%. Also in the valuation as of 9/30/2007, a general salary increase of 4.25% was assumed for FY2008, but in the valuation as of 9/30/2008, the actual salary increases during FY2008 were reflected in the actual employee population as of 9/30/2008.

Section 3 compares the change in the Postal Fund from September 30, 2007 to September 30, 2008. The fund was expected to grow to \$69.9 billion, but due to lower investment income than assumed, the fund only grew to \$69.3 billion. The investment earnings were 5.42 percent compared with the assumed 6.25 percent.

3. Analysis of Change in Net Assets during FY2008 - FERS

	<u>Expected</u>	<u>Actual</u>
Net Assets as of 9/30/2007	\$63.503	\$63.503 billion
+ Contributions	+ 3.136	+ 3.103
- Benefit Payments	- 0.773	- 0.780
+ Investment Income	+ 4.042	+ 3.504 ¹
Net Assets as of 9/30/2008	\$69.908	\$69.330

Section 4 projects the September 30, 2008 results to September 30, 2009 for financial disclosure purposes. The current surplus of \$6.5 billion is projected to increase to \$6.8 billion. This limited change indicates that, based on current information, our analysis of the effect of these assumption changes on the surplus would produce similar results as of September 30, 2010.

¹ The actual rate of return for FERS for FY2008 was 5.41756% based on the experience of the entire FERS fund while the expected rate of return was 6.25%



4. FERS Unfunded Liability Projected to 9/30/2009, Based on Long Term Assumptions

Actuarial Accrued Liability as of 9/30/2008	\$ 62.8 billion
+ Total Contributions for FY2009	+ 3.4
- Projected Benefit Payments for FY2009	- 0.9
+ Interest Expense	+ 4.0
Projected Actuarial Liability 9/30/2009	\$ 69.3
- Projected Postal Fund 9/30/2009	- 76.1
Projected Unfunded Liability as of 9/30/2009	\$ - 6.8 billion

Section 5 documents the assumptions and actuarial methods used in the calculations.

5. Cost Methods and Assumptions Underlying the Actuarial Valuations

The actuarial cost method is Entry Age Normal

The long term economic assumptions are as follows:

Rate of inflation: 3.5%
 FERS COLA: 2.8%
 Annual general salary increases: 4.25%
 Interest Rate: 6.25%

The Board of Actuaries decided to incorporate an assumption for additional future mortality improvement for the actuarial valuation as of September 30, 2007. Longer life in turn increases the cost of providing pension benefits. This caused the dynamic normal cost of CSRS to increase from 25.2% of pay to 25.8%, and the FERS normal cost to increase from 12.0% to 12.3%. It also caused an increase in the actuarial liabilities. The Postal Service is not required to make any agency contributions to CSRS. Because of budgeting considerations, the agency contribution to FERS will continue at the current



rate of 11.2% of pay (the employee contribution is 0.8% of pay) until October 1, 2010, when it will change to the new rate of 11.5% of pay.

Table of Converting Unused Sick Leave Into Additional Service <small>(Source: OPM Fact Book #8 RI 83-8)</small>												
Months	0	1	2	3	4	5	6	7	8	9	10	11
Days												
0	0	174	348	522	696	870	1044	1217	1391	1565	1739	1913
1	6	180	354	528	702	875	1049	1223	1397	1571	1745	1919
2	12	186	360	533	707	881	1055	1229	1403	1577	1751	1925
3	17	191	365	539	713	887	1061	1235	1409	1583	1757	1931
4	23	197	371	545	719	893	1067	1241	1415	1589	1762	1936
5	29	203	377	551	725	899	1073	1246	1420	1594	1768	1942
6	35	209	383	557	731	904	1078	1252	1426	1600	1774	1948
7	41	215	388	562	736	910	1084	1258	1432	1606	1780	1954
8	46	220	394	568	742	916	1090	1264	1438	1612	1786	1960
9	52	226	400	574	748	922	1096	1270	1444	1618	1791	1965
10	58	232	406	580	754	928	1102	1275	1449	1623	1797	1971
11	64	238	412	586	760	933	1107	1281	1455	1629	1803	1977
12	70	244	417	591	765	939	1113	1287	1461	1635	1809	1983
13	75	249	423	597	771	945	1119	1293	1467	1641	1815	1989
14	81	255	429	603	777	951	1125	1299	1473	1646	1820	1994
15	87	261	435	609	783	957	1131	1304	1478	1652	1826	2000
16	93	267	441	615	789	962	1136	1310	1484	1658	1832	2006
17	99	273	446	620	794	968	1142	1316	1490	1664	1838	2012
18	104	278	452	626	800	974	1148	1322	1496	1670	1844	2018
19	110	284	458	632	806	980	1154	1328	1502	1675	1849	2023
20	116	290	464	638	812	986	1160	1333	1507	1681	1855	2029
21	122	296	470	644	817	991	1165	1339	1513	1687	1861	2035
22	128	302	475	649	823	997	1171	1345	1519	1693	1867	2041
23	133	307	481	655	829	1003	1177	1351	1525	1699	1873	2047
24	139	313	487	661	835	1009	1183	1357	1531	1704	1878	2052
25	146	319	493	667	841	1015	1189	1362	1536	1710	1884	2058
26	151	325	499	673	846	1020	1194	1368	1542	1716	1890	2064
27	157	331	504	678	852	1026	1200	1374	1548	1722	1896	2070
28	162	336	510	684	858	1032	1206	1380	1554	1728	1902	2075
29	168	342	516	690	864	1038	1212	1386	1560	1733	1907	2081

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APPENDIX C: MANAGEMENT'S COMMENTS



August 6, 2010

MS. LUCINE WILLIS
DIRECTOR, OIG AUDIT OPERATIONS

SUBJECT: Audit Report–Federal Employees Retirement System Overfunding
(Report Number FT-MA-10-DRAFT)

Thank you for the opportunity to respond to the above referenced report. United States Postal Service management concurs with your assessment that the Postal Service was over-funded for its Federal Employees Retirement System (FERS) pension liability at the end of fiscal year (FY) 2009 by approximately \$6.8 billion, based upon the estimates provided by the Office of Personnel Management (OPM). Given the Postal Service's dire financial situation, the overfunded amount could be better applied to other retirement plan funding shortages. However, as we have previously discussed, legislative changes in this area are particularly challenging due to the likely negative effects on the Federal Budget.

As noted in your report, there are several factors which may affect the FY2010 and future amounts of the FERS over-funding. Notably, the OPM has recently changed certain actuarial assumptions and legislation has been passed that allows employees to credit their sick leave to their FERS pension calculations. These actions will reduce the amount of the over-funding by approximately \$1.3 billion, according to your estimates.

Additionally, with the Office of Inspector General's assistance, we are working with Congress and the Administration to address other significant issues related to our retirement plans, including the \$50 to \$75 billion overpayment of Civil Service Retirement System obligations and pre-funding issues associated with our Retiree Health Benefits plan, which has a near-term annual cost of \$5.5 billion. As there are a number of significant legislative solutions being sought for our retirement plan issues, we will need to prioritize these items to avoid overwhelming the legislative processes.

Recommendation 1. Pursue legislative action to alter the Postal Service's Civil Service Retirement and Disability Fund contributions for one or more years until the FERS surplus is extinguished.

Management agrees that legislation should be pursued if the FY2010 valuations for FERS support such action. While Congress is familiar with the Postal Service's over-funding of its Civil Service Retirement System obligation, the FERS over-funding issue is relatively new. It will take a comprehensive educational effort to inform Congress regarding this development. In addition, it should be noted that any legislative change will be challenging due to the crowded Congressional calendar and the potential Federal Budget "scoring" issues this may trigger.

Recommendation 2. Coordinate with the OPM to identify causes of actual payout differences between the Postal Service and the rest of the Federal government and use that information to reduce the risk of future surpluses.

Management agrees and we will seek the cooperation of the OPM to understand differences, if any, in pension benefit payments for Postal Service retirees versus those of the overall FERS population. With that information, better funding strategies can be determined to avoid future funding surplus or shortfall positions.

Recommendation 3. Pursue legislative action to define future distribution of significant surpluses.


Management agrees and such legislative amendments shall be pursued.

Recommendation 4. Coordinate with the OPM to create a sub-account within the Civil Service Retirement and Disability Fund exclusive to the Postal Service.

Management agrees and we will seek the cooperation of the OPM to create such accounts with the Treasury Department.

We do not believe that this report or management's responses contain information that may be exempt from disclosure under the Freedom of Information Act.


Joseph Corbett
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