

Discussion of Public Retirement Benefit Plan Designs and Financing Arrangements



**Montana Legislature
State Administration and Veterans'
Affairs Interim Committee
October 29, 2009**

**Keith Brainard
NASRA Research Director**

Presentation Summary

- **Overview of retirement benefits in the U.S.**
- **Recent trends and developments**
- **Basic plan design and financing issues**
- **Alternatives to the prevailing structure**

Retirement Benefits Comparison

Private Sector

- Two of five have no access to an employer-sponsored retirement benefit
- One-fourth of those eligible do not participate
- Fewer than one in five have a traditional pension (DB) benefit
- Some employers have suspended or eliminated their 401k plan match
- Universal Social Security

Public Sector

- Nearly all have access to an employer-sponsored retirement benefit
- Ninety percent participate in a traditional pension (DB plan)
- Three-fourths participate in Social Security

Reliance on Social Security

- More than half (56 percent) of those on Social Security rely on it for more than half of their income.
- For 30 percent of Social Security recipients, Social Security accounts for 90 percent of retirement income.
- For almost one of every five Social Security recipients, (19 percent) Social Security is the sole source of income.

Source: Social Security Administration

Why have traditional pension benefits diminished in the private sector?

- Increased competition with companies based overseas whose retirement benefits are less employer-focused
- Increased worker mobility due to a shift from manufacturing to service-based economy
- Federal regulations that create volatility and uncertainty regarding employer costs

These factors do not affect public employers.

Core Elements of a Traditional Pension Plan

- A benefit that cannot be outlived
- A benefit that reflects salary and length of service
- Assets that are pooled and professionally managed

Distinguishing features of the public sector workforce

- Public employees are older and almost twice as likely to have a college degree
- More than one-half of public sector workers are employed in career-oriented jobs:
 - For example, teachers, firefighters, police
- Pension benefits play a vital role in enabling employers to retain these workers

Best practices in retirement plan design

- Mandatory participation/automatic enrollment
- Cost-sharing between employers and employees
- Pooled assets
 - Reduce administrative costs and distribute risk
- Assets that are professionally invested
- Annuitized benefit

Notable trends affecting public pension plans

- Movement from retirement age provisions at “any age”
- Higher normal retirement age
- Higher/mandatory employee contributions
- Longer final average salary periods
- Fewer discretionary COLAs, smaller COLAs
- Increased use of hybrid plans
- Little discussion of switching to defined contribution plans

Plan design changes were underway in many cities and states before the market decline and recession

Myths surrounding public pensions

- Switching to a DC plan will save money
- DC plans are better because they offer greater portability
- A DB plan costs more than a DC plan
- Workers want a DC plan as their primary retirement benefit

Concerns with defined contribution plans as the primary retirement benefit

- DC plans are unreliable vehicles for attaining retirement security because of the likelihood of insufficient asset accumulation and income replacement
- DC plan costs erode account values
- DC plans suffer from leakage via loans, withdrawals, and pre-retirement cash-outs
- DC plans typically have no annuitization requirement and leave investment decisions to amateur investors
- DC plans do not promote an orderly turnover of workers
 - An older worker who cannot afford to retire will remain on the job

Defined contribution plans were created to serve as a supplemental, not primary, retirement benefit

- DC plans were created as a vehicle for highly paid corporate executives to shelter income from taxes

A sample of changes made this year to statewide public pension plans

- Higher pension contribution rates for new or existing participants: NE, NH, NM, NV, OK
- Higher normal retirement requirements: NM, TX
- Early retirement incentives: CT, LA, ME, VT
- Restrictions on returning to work after retirement: AR, GA, IN, KS, TX
- These are likely to be a precursor to changes in 2010 and beyond. Ohio is considering widespread plan design and financing changes to all statewide plans, including include higher ee and er contributions, higher retirement eligibility requirements, lower COLAs, and others.

Other changes likely to be considered

- Retirement age:
 - “any age” and under age 55 provisions
- Required years of service to qualify for retirement
- New or higher employee contributions
- Adjustments to cost-of-living adjustments
- Retirement multiplier
 - Modify for current workers’ future service?
- Final average salary calculation
 - 3, 5, 10 years?

Nebraska and West Virginia found a DC plan to not work for their employees

- Nebraska offered its state and county workers only a 401(k) plan until 2003
- Observations and studies found that plan participants were reaching retirement financially unprepared
- Switched to a cash balance, hybrid plan
- West Virginia closed its teachers' DB plan in 1993, due to poor funding condition
- New hires were placed in a 401(k) plan
- Reopened in 2005 after a basically bad experience with DC plans

Cash balance plan for state and county workers in Nebraska

Until 2003, state and county workers in Nebraska had only a defined contribution plan; a study found these workers were reaching retirement age financially unprepared

Legislators sought to implement a retirement benefit with DB plan elements at no additional cost relative to the legacy DC plan

Cash balance plan for state and county workers in Nebraska

- Includes new hires as of 1/1/03 plus the DC plan participants who elected to switch
- Same EE and ER contribution rates as the DC plan: 4.8% and 7.49%
- Pooled assets invested in a diversified portfolio

Cash balance plan for state and county workers in Nebraska

- Normal retirement: age 55 with 3 years of service
- Postponing retirement increases benefits by both reducing the payout period and increasing the cash balance
- Any portion of the cash balance may be annuitized
- An auto COLA and joint/survivor benefits are optional

The Texas Municipal and County & District plans also are cash balance plans, but with different plan design features

Cash balance plan for state and county workers in Nebraska

- Accounts receive a guaranteed return of the greater of a) 5.0% or b) a smoothed rate tied to a basket of federal bonds plus 1.5%
- PERS board may approve an additional dividend if prescribed actuarial conditions are met

Year	Earnings Credit	Dividend Credit*	Total Credit Applied
2003	5.04%	0.0%	5.04%
2004	5.19	3.08	8.27
2005	5.45	2.80	8.25
2006	6.27	13.05	19.32
2007	6.12	2.73	8.85
2008	5.02	5.26	10.28
2009	5.00	0.0	5.00
AVG	5.44%	3.85%	9.29%

* Dividend credits are based on previous year's investment experience.

Individual Account Plan sponsored by the Oregon PERS

In 2003, the Oregon PERS funding level was dropping sharply and costs were rising to unsustainable levels

Oregon legislators had the following objectives:

1. Preserve core DB plan elements
2. Restore sustainability of the DB plan
3. Share investment risk with employees
4. Give retiring/terminating participants access to a lump sum

Individual Account Plan sponsored by the Oregon PERS

- New hybrid plan:
 - Traditional DB plan with a reduced multiplier of 1.5 percent (1.8 percent for police & fire)
 - Mandatory participation in the Individual Account Plan, which is a DC plan
 - IAP contributions go into a pooled fund invested in the same manner as the DB fund

Individual Account Plan sponsored by the Oregon PERS

- IAP assets are professionally invested at in a diversified portfolio
 - Low investment expenses
 - Participants do not need to make investment decisions
- At retirement or termination, participants may take DC plan assets as a lump sum, annuity, or amortized over 5-, 10-, 15- or 20-year periods

Individual Account Plan sponsored by the Oregon PERS

- IAP accounts were credited an average of 4.66 percent from 2004 to 2008
- DB plan's funding level has improved significantly and contribution rates have declined dramatically
 - This improvement will be reversed somewhat as the effects of the 2008 market decline are recognized
- Other states, including Washington, Ohio, Indiana, and Georgia (for new hires as of 1/1/09), have similar DB/DC plan designs

Supplemental DC plan opportunities

- Supplemental DC plan auto enrollment
 - Established in recent years for state employees in Texas and Virginia
 - Employer match or contribution
 - Plans that make a contribution to supplemental DC plans for participating workers experience sharply higher participation rates

Key Takeaways

- Movement of private employers from traditional pensions is rooted in factors largely irrelevant to public sector employers
- Reliance on defined contribution plans has diminished the nation's retirement security
- Best practices in retirement plan design include
 - Mandatory participation or automatic enrollment
 - Employee/employer cost sharing
 - Pooled assets that are professionally invested
 - Required annuitization
- A hybrid, containing elements of both DB and DC plans, can meet objectives of all relevant stakeholders: public employers, employees, and taxpayers

More information

- www.nasra.org
- www.publicfundsurvey.org
- Keith Brainard, NASRA Research Director
 - keithb@nasra.org
 - 512-868-2774