NEBRASKA RETIREMENT SYSTEMS COMMITTEE

Interim Study Report
Legislative Resolution 422

General Principles of Sound Retirement Planning

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LR 422 – General Principles of Sound Retirement Planning

INTRODUCTION

The Nebraska Retirement Systems Committee was designated by the Legislature to conduct an interim study, as proposed in LR 422, 101st Neb. Leg., 2nd Sess. (2010). The Committee was further instructed upon the conclusion of its study, to make a report of its findings, together with its recommendations, to the Legislative Council or Legislature. The following constitutes the report of the Nebraska Retirement Systems Committee.

PURPOSE

The purpose of this study is to review and update the General Principles of Sound Retirement Planning. The General Principles of Sound Retirement Planning are utilized by the Nebraska Retirement Systems Committee as a guide to evaluate proposed legislation and issues regarding Nebraska's public retirement systems. The General Principles are also used by the Legislature as a guide on each of the retirement systems administered by the Public Employees Retirement Board and those systems not administered by the board.

METHODOLOGY

An interim hearing was held on September 24, 2010, to discuss amending the General Principles of Sound Retirement Planning. The findings and recommendations of this interim report arise out of information and testimony given at the hearing.

FINDINGS

The General Principles of Sound Retirement Planning, as amended by the Nebraska Retirement Systems Committee, has been attached to this report representing the findings for the purposes of this interim study:

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RESOLUTION SUMMARY—LR 422

Background

The General Principles were developed in the 1970's and revised in the 1980's. Following the completion of the comprehensive retirement study originally authorized by LR 328 in 1992 and finalized by LR 383 in 1994, the Retirement Committee reviewed the General Principles under LR 164 in 1995, and adopted revisions on April 11, 1996. The General Principles were further studied and reviewed and the five public retirement systems benefits were analyzed under LR 336 in 2000 and reviewed and amended under LR 339 in 2006. The General Principles are intended to be reviewed and updated every five years.

Proposed Changes

I. C. **All proposed legislative changes in retirement systems must be actuarially sound and supported by an actuarial study, if necessary, to evaluate the cost of the proposal and the fiscal impact on the State of Nebraska.**

COMMENTS: 1) Any change in benefits must carry a provision to pay for these benefits. See Rules of the Nebraska Unicameral Legislature, Rule 5, Section 15 adopted by the Legislature in 1996.

II. A. **When possible, retirement provisions should be added, amended or deleted uniformly or consistently among the various public retirement systems covering different groups of public employees.**

COMMENTS: 1) Revisions to one defined contribution plan should be considered for the other defined contribution plan(s). Revisions to one defined benefit plan should be considered for the other defined benefit plan(s). Revisions to one cash balance plan should be considered for the other cash balance plan(s). 2) Uniformity and consistency across defined benefit, ~~and~~ defined contribution, and cash balance plans should be attempted when appropriate. 3) Variations between plans may be justified based upon funding, unique membership needs, objectives unrelated to benefit adequacy, or other rationales. Justification for variations should be carefully examined.

II. B. **Each employee authorized to participate within a retirement system should be treated equitably and without discrimination.**

COMMENTS: 1) Each employee authorized to participate in a given system should be treated equitably with other employees authorized to participate in the same system with similar demographics. 2) Provisions should not unfairly advantage nor disadvantage a group of employees authorized to participate within a system.

III. D. **Prior to adopting additional benefit enhancements for a defined benefit plan, ~~there should be~~ a reasonable reserve amount should be established with the plan in order to reduce the need ~~for~~ to make future required actuarial contributions ~~to be made~~ during periods when actual investment**

returns are less than the actuarially assumed rate of investment returns. If such reserve does not exist at the time a benefit enhancement is proposed, then a required reserve amount or percentage should be implemented in conjunction with the adoption of the benefit enhancement.

IV. C. **Vesting provisions should be included in the various retirement systems.**

COMMENTS: 1) Vesting provisions are important in any well-developed pension plan, so that long-service employees who terminate do not lose all their accrued benefits. On the other hand, the governmental employer should not feel compelled to provide full vesting immediately upon entry into the plan. Some short period of service before vesting commences is reasonable. 2) Full vesting should occur after three years of service <u>for members of the defined contribution and cash balance plans</u>. 3) The employee should always be fully vested in his or her own contributions. Employee contributions should be credited with a reasonable rate of interest that is consistent among the various retirement systems.

V. A. **Future liberalizations in benefits under existing systems may be made for service both prior to and subsequent to the date of improvement for active members under a defined benefit plan. For members who have retired under either a defined benefit, ~~or a~~ defined contribution, <u>or cash balance</u> plan prior to enactment of legislation, only cost-of-living adjustments may be made.**

V. D. **Cost-of-living adjustments should be provided to maintain benefit adequacy during post-retirement inflation. When possible, any specific recognition of changes in the cost of living in plan provisions should be made on a uniform basis for all systems.**

COMMENTS: 1) When a cost-of-living adjustment is provided in one system, a cost-of-living adjustment should be considered and encouraged in the other systems since inflation affects all groups of employees. 2) While cost-of-living mechanisms should be uniform among the defined benefit plans and uniform among the defined contribution <u>and cash balance</u> plans, mechanism(s) for the defined benefit plans may differ from the mechanism(s) for the defined contribution <u>and cash balance</u> plans. 3) Any cost-of-living benefits that are adopted must be funded according to sound actuarial principles.

General Principles of Sound Retirement Planning

Background

The following is a list of general principles of sound retirement planning ("General Principles") to be applied by the Nebraska Retirement Systems Committee during the legislative sessions and interim sessions. The General Principles were developed in the 1970's and revised in the 1980's. Following the completion of the comprehensive retirement study originally authorized in LR 328 (1992) and finalized in LR 383 (1994), the Retirement Committee reviewed the General Principles under LR 164 (1995) and adopted revisions on April 11, 1996. The General Principles were further studied and reviewed and the five public retirement systems benefits were analyzed under LR 336 (2000). The General Principles were further studied and amended under LR 339 (2006) and LR 422 (2010).

These principles are to be reviewed and updated every five years.

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I. Application of the General Principles & Evaluation of Legislation.

I. A. **The Legislature has the responsibility of developing sound and adequate public retirement systems for Nebraska public employees. The Nebraska Retirement Systems Committee has developed and will periodically review the General Principles of Sound Retirement Planning ("General Principles"). The principles will be applied to any state administered public retirement system as well as public retirement systems specifically provided by statute. Other public retirement systems administered by political subdivisions and generally provided in statute should utilize the principles as guidelines.**

COMMENTS: 1) The General Principles should be reviewed and updated at least once every five years. 2) Since most political subdivisions lack the size and expertise necessary to provide sound and adequate retirement systems on their own, the Legislature has a responsibility to provide general guidelines for all political subdivisions to use in designing their systems. Although the Legislature has a responsibility to provide guidelines, in general all political subdivisions are responsible for the financing of these systems so that the state has no direct financial obligation resulting from the guidelines.

I. B. **All proposed changes in retirement systems should be measured against these General Principles.**

COMMENTS: 1) No change should be made in any retirement system without measuring it against these General Principles. Since these principles do not specifically cover every situation, some extension, elaboration, and interpretation of these principles in practice will be necessary. 2) Any proposed change that violates one or more of these principles must be carefully scrutinized to see if an exception to the principles is warranted or if the principle needs revision.

I. C. **All proposed legislative changes in retirement systems must be actuarially sound and supported by an actuarial study, if necessary, to evaluate the cost of the proposal and the fiscal impact on the State of Nebraska.**

COMMENTS: 1) Any change in benefits must carry a provision to pay for these benefits. See Rules of the Nebraska Unicameral Legislature, Rule 5, Section 15 adopted by the Legislature in 1996.

II. Retirement System Objectives.

II. A. **When possible, retirement provisions should be added, amended or deleted uniformly or consistently among the various public retirement systems covering different groups of public employees.**

COMMENTS: 1) Revisions to one defined contribution plan should be considered for the other defined contribution plan(s). Revisions to one defined benefit plan should be considered for the other defined benefit plan(s). Revisions to one cash balance plan should be considered for the other cash balance plan(s). 2) Uniformity and consistency across defined benefit, defined contribution, and cash balance plans should be attempted when appropriate. 3) Variations between plans may be justified based upon funding, unique membership needs, objectives unrelated to benefit adequacy, or other rationales. Justification for variations should be carefully examined.

II. B. **Each employee authorized to participate_within a retirement system should be treated equitably and without discrimination.**

COMMENTS: 1) Each employee authorized to participate in a given system should be treated equitably with other employees authorized to participate in the same system with similar demographics. 2) Provisions should not unfairly advantage nor disadvantage a group of employees authorized to participate within a system.

II. C. **Retirement plans should be designed to provide adequate retirement benefits for employees who complete a period of service considered to be a normal career. Benefit adequacy should be based upon the income replacement needed to maintain the same standard of living during retirement as before retirement. Sources of income replacement should include the base retirement benefit under the public system, the Social Security benefit if earned during employment covered by the plan, and assumed voluntary savings.**

COMMENTS: 1) A normal career may vary by retirement system; however, in general, a normal career equals 25 years of service for county employees, state employees, school employees and state patrol members, while it equals 20 years for judges due to their appointment later in their career. The employer should not be obliged to provide full benefits to an employee hired within a short period of time before normal retirement age. 2) Postretirement income replacement needs should factor in the net change in out-of-pocket expenses. 3) An income replacement objective for an average-paid employee during the first year of retirement of at least 83% for State, 86% for County, 78% for School and 71% of compensation during the year prior to retirement is considered adequate due to the more favorable tax position of the retiree, reduced work-related expenses, and discontinuation of personal savings programs. Since State Patrol officers do not participate in Social Security, the income replacement objective for an average-paid State Patrol officer is at least 85% of compensation. Higher income replacement objectives may be needed since lower-paid employees have higher income replacement needs. 4) Voluntary savings should be assumed to be at least 1% of compensation for the State, County, School, and Judges plans and at least 3% of compensation for the State Patrol plan due to non-participation in Social Security which requires higher personal savings by state patrol officers. 5) The retirement benefit levels indicated are to be measured on the Life Annuity Option for a single employee. 6) Postretirement inflation protection should be included in evaluating benefit adequacy.

II. D. **In determining benefit adequacy, Social Security benefits should be taken into consideration for employment covered under the public plan. Changes in social security benefits may require revisions to the base benefits provided under the public plan.**

COMMENTS: (1) Base retirement benefits under the public plan may need to increase to offset reductions in Social Security and to achieve adequate benefit for retirees.

II. E. **For groups covered under Social Security, auxiliary benefits in the retirement system, such as death and disability benefits, are incidental and should not be a major portion of the total benefit package.**

COMMENTS: 1) Major death and disability coverage can best be handled by separate insurance programs outside the retirement systems. More substantial death and disability benefits in the retirement system are appropriate for those groups not covered under Social Security to compensate for the lack of auxiliary benefits provided under Social Security.

II. F. **Base retirement benefits provided by a public employer should be provided directly under the retirement system.**

COMMENTS: 1) Providing retirement benefits outside the retirement system leads to hidden costs, unsound funding, and splintering of the retirement system. 2) Allowing supplemental plans in addition to the basic retirement system for certain employees is also generally poor policy. 3) This principle is not intended to apply to Social Security benefits or voluntary tax deferred programs that may be available to employees of a retirement system. 4) Benefit adequacy should include all benefits as described in principle II-C.

III. Funding of the Retirement System.

III.A. All public retirement systems, including those in the political subdivisions, should be pre-funded according to sound actuarial principles, and benefits should not be paid out of current revenues.

COMMENTS: 1) Pre-funded plans lead to a significant reduction in the total cost of the plan because of the effect of investment income on the fund. 2) Pre-funded plans produce a greater degree of security to the employees that the money will be there to pay the benefits when they retire. 3) Pre-funded plans lead to greater flexibility in making contributions to the system. 4) Although pensions paid out of current revenues may have a certain political appeal because the dollar outlay is very small in the early years of the plan, the costs will spiral greatly as the plan matures. Pre-funded plans show a more level incidence of costs. 5) Pensions paid out of current revenues require future generations of taxpayers to pay for benefits that have been accrued in the past. Benefits should be paid for as they are being earned. 6) Pensions paid out of current revenues lead to large unfunded liabilities which have many similarities to indebtedness and are contrary to the spirit of the Constitution of the State of Nebraska.

III. B. Unfunded liabilities are to be amortized so as to reduce the unfunded liability to zero in 30 years, or less, from the date the liability is identified by the actuary. Long-term costs and the amortization of unfunded liabilities should maintain generational equity.

COMMENTS: 1) Unfunded liabilities occur due to a) inception of a new retirement system, b) benefit improvements, or c) actual experience that differs from actuarial assumptions, i.e. investment, retirement rates, etc. 2) Currently, unfunded liabilities under the state administered plans are amortized by level annual payments over either a) 30 years (School Employees) or b) the lesser of 30 years or the average expected future service of the active members (Judges & State Patrol). Any new systems covering new groups of employees not previously covered should require full funding within 30 years of their date of inception. 3) Generational equity means that each generation of employees and employers pays an equitable cost for retirement benefits accruing for those employees. If benefits for a particular generation of employees are not adequately funded, future generations of employees and employers will be required to pay for those benefits for current employees. 4) Funding methodology must be specified in the plan document. 5) A shorter amortization period is appropriate when the unfunded liability arises as a result of benefit improvements for retired participants, in order to provide adequate funding of the increased benefits during the remaining lifetime of the retired participants.

III. C. **Each retirement system should be funded so that the actuarial present value of assets will be equal to 90%-110% of the Projected Benefit Obligation (PBO).**

COMMENTS: 1) Adequate funding is essential to maintain the integrity of the retirement system. 2) Under GASB, funding status is measured by comparing actuarial value of assets with the actuarial present value of projected benefits.

III. D. **Prior to adopting additional benefit enhancements for a defined benefit plan, a reasonable reserve amount should be established with the plan in order to reduce the need to make future required actuarial contributions during periods when actual investment returns are less than the actuarially assumed rate of investment returns. If such reserve does not exist at the time a benefit enhancement is proposed, then a required reserve amount or percentage should be implemented in conjunction with the adoption of the benefit enhancement.**

IV. Retirement System Design.

IV. A. **Reasonable eligibility requirements are a part of any well-designed retirement system.**

COMMENTS: 1) Establishing reasonable age and service requirements for participation in a retirement system is appropriate and is not contrary to public policy. 2) Coverage should be extended to full-time permanent employees. Consideration should be given to including permanent part-time employees. Temporary employees may be excluded. 3) Once an employee satisfies the eligibility requirements, participation in the retirement system should not be voluntary, but should be a mandatory condition of employment. Voluntary participation should be considered for employees who have not met the mandatory requirements when administratively feasible. 4) An employee should be eligible to participate in only one specific retirement system, in addition to the Deferred Compensation 457 Plan.

IV. B. **Member contributions should be established at a rate so that a new employee entering at age 35 or under will pay no more than 50% of the total contributions to his or her plan.**

COMMENTS: 1) Funding of the retirement systems should be reviewed periodically to determine the proportion of funding by various sources, i.e. employee, employer, and/or the State. 2) Total contributions should be established to fund benefits in order to meet the income replacement objectives under principle II-C and funding ratio as defined in principle IIIC.

IV. C. **Vesting provisions should be included in the various retirement systems.**

COMMENTS: 1) Vesting provisions are important in any well-developed pension plan, so that long-service employees who terminate do not lose all their accrued benefits. On the other hand, the governmental employer should not feel compelled to provide full vesting immediately upon entry into the plan. Some short period of service before vesting commences is reasonable. 2) Full vesting should occur after three years of service for members of the defined contribution and cash balance plans. 3) The employee should always be fully vested in his or her own contributions. Employee contributions should be credited with a reasonable rate of interest that is consistent among the various retirement systems.

IV. D. Employees who continue their employment beyond the normal age of retirement should continue to participate in the retirement systems.

COMMENTS: 1) As participants of the retirement system, these employees should continue to earn additional retirement benefits for years of service following the normal retirement age. 2) These employees should continue to make contributions as the system requires for participants.

IV. E. Optional forms of benefit payments should be available at retirement and calculated as actuarial equivalents to the normal form of benefit.

COMMENTS: 1) Optional forms of benefits should be available to increase the flexibility of the retirement system in order to adequately meet the needs of retirees in different situations. 2) All options should be actuarial equivalents of the normal form of the benefit. 3) Lump sum payment under the defined contribution plans shall be one of the options available.

IV. F. All early retirement benefits should be reduced due to the longer period of benefit payments.

COMMENTS: 1) Employees who retire prior to attaining the normal retirement age should be provided a benefit that is reduced to reflect the longer period over which they will receive benefits. 2) Reductions should be made so as to minimize the additional cost to the retirement system for the reductions.

IV. G. Transferability of credits among the various retirement systems should be provided to the extent transfers are legally and financially possible.

COMMENTS: 1) Steps should be taken to increase reciprocity among the various public retirement systems in Nebraska by providing transferability of credits to the extent such transfers are legally and financially possible. 2) Special consideration may be given to those situations in which the transfer of employment between systems is involuntary.

V. Revisions in Plan Design.

V. A. Future liberalizations in benefits under existing systems may be made for service both prior to and subsequent to the date of improvement for active members under a defined benefit plan. For members who have retired

under either a defined benefit, ~~or a~~ defined contribution, <u>or cash balance</u> plan prior to enactment of legislation, only cost-of-living adjustments may be made.

COMMENTS: 1) Increases in retirement benefits under a defined benefit plan for service subsequent to the date of improvement shall be funded according to sound actuarial principles during the period the benefits are accruing. 2) Increases in retirement benefits under a defined benefit plan for service prior to the date of improvement will result in an increase in the unfunded liability of the system and generational shifts of costs, which should be identified and considered. This unfunded liability shall be amortized in accordance with Principle III-B. 3) Under Nebraska's Constitution, retirement benefits of retired public officers and employees may be adjusted to reflect changes in the cost of living and wages levels that have occurred subsequent to the date of retirement. Other benefit improvements cannot be made for members who have ceased employment prior to enactment of the improvements.

V. B. **The employer should pay a greater portion, if not all, of the cost of any past service benefit.**

COMMENTS: 1) Granting past service benefits will generally result in an increase in the unfunded liabilities of the system and generational shift of costs. 2) The employer should adopt a funding policy consistent with Principle III-B to reduce the unfunded liability to zero. 3) The effects on generational equity should be recognized and considered when determining contributions by current and future employees.

V. C. **Buy-back provisions may be appropriate for purchasing credit for specified periods of service. All buy-back proposals should be evaluated on the following: (1) The buyback provision should not provide a significant indirect or unintended subsidy to the employee buying the service at the expense of continuing members; (2) Buy-back opportunities should not be expanded without an actuarial fiscal note of the likely cost of a provision; (3) Any "discount" to the expected cost of a buy-back provision should be disclosed and taken into account in the actuarial valuation of the system; (4) The buy-back provision should not allow purchase of service credit if another benefit will be provided for the same period of service; and (5) The experience of the buy-back provisions should be monitored so that adjustments can be made as necessary to the contributions required of employees.**

COMMENTS: (1) The cost of purchasing prior service credit should not be shifted to other members in the system. (2) Subsidies should be identified and monitored from inception of the buy-back provision. (3) "Double dipping" or receipt of two or more benefits for the same period of service should be avoided.

V. D. **Cost-of-living adjustments should be provided to maintain benefit adequacy during post-retirement inflation. When possible, any specific**

recognition of changes in the cost of living in plan provisions should be made on a uniform basis for all systems.

COMMENTS: 1) When a cost-of-living adjustment is provided in one system, a cost-of-living adjustment should be considered and encouraged in the other systems since inflation affects all groups of employees. 2) While cost-of-living mechanisms should be uniform among the defined benefit plans and uniform among the defined contribution and cash balance plans, mechanism(s) for the defined benefit plans may differ from the mechanism(s) for the defined contribution and cash balance plans. 3) Any cost-of-living benefits that are adopted must be funded according to sound actuarial principles.

V. E. **Proposals to divide or fragment a retirement system, or provisions under a retirement system, should be evaluated upon the following: (1) Increased costs and/or inefficiencies; (2) Qualification concerns under federal law; and (3) Real need for disparate treatment of an identified class of employees.**

COMMENTS: (1) The fragmentation of a retirement system, or provisions of a retirement system, may lead to additional costs and nondiscrimination concerns.

VI. Retirement System Administration.

VI. A. **All retirement systems should be designed and administered in compliance with state law, the Internal Revenue Code and the associated regulations, other federal law, and generally accepted accounting principles.**

COMMENTS: 1) The systems should be administered in compliance with state and federal laws. 2) Although "ERISA" does not apply to governmental pension plans, several provisions are also contained in the Internal Revenue Code and are applicable to governmental pension plans. [See ERISA 29 USC §1003 (b)(1) and §1321 (b)(2)] 3) The administering board should ensure that all pension fund accounting follows generally accepted accounting principles.

VI. B. **Administration of the various systems should be performed by a qualified board and qualified staff. The board should administer the system solely in the interests of the members and beneficiaries of the retirement systems for the exclusive purposes of providing benefits to members and members' beneficiaries and defraying reasonable expenses incurred. The board should include employee representatives.**

COMMENTS: 1) The administering board should have knowledge of retirement systems and/or experience in management. 2) The board should hire a qualified director and other qualified staff as may be required to properly administer the systems. 3) Administrative expenses of the board should be financed by the retirement systems and not by general fund revenues.

VI. C. **Each public retirement system should submit an annual report to the appropriate governing body. For state-administered plans, the annual report should be submitted to the Legislature and the Governor.**

COMMENTS: 1) Annual reports of each public retirement system should be provided to the Nebraska Retirement Systems Committee. The annual reports are in addition to, but may include, any actuarial valuation of the system.

VI. D. **Each public defined benefit retirement system should have periodic actuarial valuations of the pension assets performed by an independent actuarial consulting firm.**

COMMENTS: 1) Actuarial valuations of the system's assets by a qualified actuarial consulting firm should be completed on a regular, defined schedule. 2) For the state-administered retirement systems, actuarial valuations should be completed annually. 3) In addition to the actuarial valuations, an analysis of the demographic and financial experience of the system should be completed at least once every five years.

VI. E. **Each retirement system should be independently reviewed by a professional consultant, with expertise in public pension plans.**

COMMENTS: 1) For the state-administered retirement systems, an external compliance audit should be performed at least once every five years. 2) Internal controls should be established to prevent or detect noncompliance. 3) Internal reviews should be completed as needed. 4) Periodic external reviews of plan design should be completed to determine the need for modification. 5) Any modifications necessary should be accomplished on a basis consistent with the other general principles.

VI. F. **Each public retirement system should communicate with the members of the system and inform them of any developments at the state or federal level affecting the benefits or provisions of their retirement system.**

VI. G. **Comprehensive retirement planning should be available to all public employees.**

COMMENTS: 1) A comprehensive pre-retirement planning program should include information and advice regarding the many changes employees face upon retirement: retirement income, employment, physical and mental health, housing, family life, and leisure activity.

VII. Investment of Pension Funds.

VII. A. **The statutes should allow the flexibility to pursue a prudent investment policy that will maximize investment yields consistent with sound investment principles. Investments should be made solely in the interests of the members and beneficiaries of the retirement systems for the**

exclusive purposes of providing benefits to members and members' beneficiaries and defraying reasonable expenses incurred. No retirement funds should be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives. Investment of state administered retirement funds should be consolidated in an entity with expertise in investing.

COMMENTS: 1) The decision concerning the investment medium should be based on competent professional advice and free of political pressures that might impair yields.

VII. B. **Return on investment of retirement funds should be independently reviewed by a professional consultant, with expertise in the area, every five years to see that they are being maintained on an adequate, sound and consistent basis.**

COMMENTS: 1) An internal review of investment performance of the major state retirement systems should be made annually. 2) An external review of investment performance by an independent consultant should be completed every five years.