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Look Before You Leap

The Unintended Consequences of Pension Freezes

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Introduction

Americans are increasingly worried about their retirement security in the face of falling home values, turmoil in the financial markets, and general economic instability. This insecurity can, at least in part, be attributed to the fact that fewer workers and retirees are able to count on a secure, predictable monthly pension, as more employers in the private sector have “frozen” participation in their pension plans. The trend away from traditional defined benefit pension plans in the private sector in favor of individual retirement savings accounts (such as those found in defined contribution plans) has left Americans especially vulnerable to the volatility in financial markets.

With the economy becoming weaker, many state and local governments will be facing fiscal challenges in the months and years ahead. These challenges will undoubtedly prompt governments to carefully examine all aspects of their budgets, including pension costs for state and local workforces. Policymakers may be wondering, “Are secure retirement benefits for our employees still affordable?” or “Should we consider shifting to a defined contribution approach?”

This brief explores important factors public employers should keep in mind when making decisions about their retirement programs. We conclude that caution should be the watchword for governments that might be tempted to follow

the trend in the private sector to abandon defined benefit (DB) pensions in favor of defined contribution (DC) plans.

Key Findings

We find that freezing DB plans can have several serious, unintended consequences.

- Freezing a DB pension and moving to a DC plan can increase costs to the employer/taxpayer at exactly the wrong time. This is because ...
 - Maintaining two plans is more costly than operating just one;
 - Forgoing and undermining the economic efficiencies of DB pensions drives up retirement plan costs; and
 - Accounting rules can require pension costs to accelerate in the wake of a freeze.
- Freezing a DB pension and moving to a DC plan can worsen retirement insecurity, potentially damaging recruitment and retention efforts.

Because of this, most states that have studied whether to freeze a DB and switch to a DC plan have found continuation of the DB plan to be in the best interests of employers/taxpayers and employees.

and employees will be required to maintain the same level of benefit in the DC plan.

Of course, employers/taxpayers could save money by cutting retirement benefits, but by forfeiting the economic efficiencies embedded in DB plans, a switch to a DC will entail an even greater reduction in benefits than what would otherwise be required if benefits in the DB plan were modified. Moreover, benefit cuts (whether within a DB plan or as part of a DB-to-DC switch) would not be without repercussions (a point to which we return later).

Worse still, the frozen DB plan will, over time, see its economic efficiency erode. This is because freezing the plan prematurely accelerates the age profile of the plan, which can force changes to how the plan's assets are invested.

To illustrate this process, consider the advice that individuals in DC plans typically receive to gradually change their investment mix as they approach retirement age, forgoing higher return/higher risk assets like equities in favor of lower return/lower risk assets like bonds. While this is done for a good reason (to protect against market shocks later in life) it necessarily involves the sacrifice of some expected return. Unlike individuals, open (i.e. non-frozen) DB plans do not age. An open DB plan will have a mix of younger, middle-aged, and older participants, and for a mature plan, this mix will not change much over time. This means that an open DB plan can achieve better returns by maintaining a more diversified portfolio over time, as compared with individuals in DC plans who must shift to a more conservative asset allocation as they get closer to retirement age. Freezing the plan sacrifices valuable investment earnings employers/taxpayers could have profited from had newer hires still been covered by the plan.

The third reason why freezing a DB plan can drive up costs has to do with the accounting rules that govern public pension plans. These rules can cause an acceleration of required pension contributions—specifically, those to cover “unfunded liabilities”—in the wake of a freeze.

“Unfunded liabilities” exist in a DB plan when the value of assets in the pension trust is smaller than the value of plan's benefit obligations. A gap between the value of the assets in a plan and the plan's obligations can emerge for several reasons. For instance, unexpected events, such as a drop in the value of the fund's assets resulting from a shock to financial markets can lead to unfunded liabilities. But decisions on the part of the employer can also play a role—for instance an employer that fails to make required contributions to the plan, or that improves benefits in the plan without making commensurate contributions to pay for these, can also see unfunded liabilities develop in the plan.

Whether a DB plan is open or frozen, the obligation to pay for benefits earned in the past will remain. However, all the benefits in a pension plan do not become payable right away, because employees will only gradually become eligible to start drawing pension benefits. Accounting rules recognize this fact and allow these obligations to be paid for over time. But the Government Accounting Standards Board (GASB) does have rules prescribing exactly how this may occur.⁹

According to GASB, the payment period to fund these liabilities may be no more than 30 years and payments can be made either in level dollar amounts, or as a level percentage of the projected payroll of the active employees in the plan. In an open plan, payroll can be expected to continue to grow over time, as retiring employees are replaced by new hires, and average pay increases each year.

As a result, payment schedules in open plans can see the dollar amount of payments gradually increase, at the same rate as the growth in payroll. But once a plan is frozen to new entrants, the number of active members in the plan will steadily fall, as individuals retire, meaning an ever-smaller payroll base over which to spread payments. Because of this, accounting rules require that if a plan is frozen to new entrants, either the unfunded liability must be paid in level dollar amounts, or as a level percent of a decreasing payroll.

traditional DB pension and DC plan, overwhelmingly the workers choose the DB plan.

A mere 3.3% of employees, for example, in the Ohio Public Employee Retirement System (PERS) elected the DC plan over the DB pension when offered, while 63% of Washington State PERS members chose an all-DB plan over the default of a combined DB and DC plan.¹⁷

And, as lawmakers in West Virginia found out, the preference among state employees in favor of DB plans can actually work to the state's financial advantage as well. After the once-frozen DB plan (TRS) was reopened to new hires, the state allowed teachers who had been hired into the DC plan (TDC) to choose whether they wanted to remain in TDC, or switch over to TRS. The state's retirement board had estimated that 10 percent or fewer of younger teachers (under 40 years old) would opt back into the DB plan, given the widely held notion that DC plans are more popular among younger workers. But an overwhelming number of these younger teachers—over 75 percent of them—decided to make the switch back to the TRS. Because so many younger employees made the switch, this had the effect of reducing the cost of re-opening the DB plan. A far cry from its initial \$78 million cost estimate, West Virginia is now estimating that the switch to the DB will actually save the state \$22 million.¹⁸

These revealed preferences for DB plans suggest that the plans are very important in attracting and retaining public sector employees. Thus, experts warn that freezing these plans and switching to DC plans can hamper recruitment, and even result in high turnover rates, labor shortages, increased training costs, and lower levels of productivity.¹⁹

Studies Have Found that Freezing DB Plans and Switching to DC Costs More

Time after time, when states have studied whether to freeze a DB pension plan and move to a DC plan, they have found the cost of switching to be prohibitive. In Kansas, for example, a recent feasibility study found that moving to a DC plan would be significantly more expensive than

a DB system, so a new, modified DB plan was implemented for new hires instead.²⁰

A 2007 study conducted for the Employees' Retirement System of Rhode Island (ERSRI) found that, should the DB plan be frozen, the state would have to substantially *increase* payments to the ERSRI for several years in order to stay in compliance with governmental accounting rules. After some time, the study's authors found, payments to ERSRI may decline; however, they did not take into account any costs of administering or contributing to a replacement DC plan, costs that would undoubtedly offset much of these savings.²¹

In 2005, a similar study examined whether New Mexico should freeze its DB plan and adopt a DC plan for newly-hired teachers. It found that such a move could "not produce 'same or better' benefits," and that the change would result in either a decrease in retirement benefits, an increase in the plan's total cost, deterioration of the funded position of the frozen DB plan, or some combination of these three scenarios.²²

Conclusion

Considering the costs and complexities of freezing DB plans and switching to DC plans, it is perhaps not surprising that most state and local governments have chosen to retain their pension plans. Although some public employers have had to make the difficult decision to reduce benefits because of tight budgetary constraints, they have generally found that modifying benefits within the existing DB pension framework has been the more cost effective option, rather than freezing the pension plan and instituting a new DC plan.

Certainly, the private sector trend of freezing DB plans and moving to DC plans is an unfortunate trend that has had serious, negative ramifications for many workers' retirement security prospects. The current economic turmoil has magnified this insecurity. Luckily, public sector employers can avoid the same regrettable results for their workforces by exercising caution, and allowing the facts to guide decision-making. In other words, policy makers are wise to look before they

¹⁰ Alaska Retirement Management Board. 2006. Minutes of October 2-4, 2006 Meeting. at <http://revenue.state.ak.us/treasury/programs/programs/other/armb/meetings.aspx>

¹¹ Consolidated Public Retirement Board & Buck Consultants, LLC. 2008. *Individual Voluntary Option for Members of the Teachers' Defined Contribution (DC) Retirement System to Transfer to the Teachers' Retirement System (TRS)*. Retirement Choice Decision Guide, CPRB.

¹² Mathis, N. 1989. "W. Virginia pension fund going broke, union says." *Education Week*. September 28, 1989.

¹³ Levitz, J. 2008. "When 401(k) investing goes bad: Teachers in West Virginia offer a valuable lesson for what not to do." *The Wall Street Journal*. August 4, 2008.

¹⁴ Anderson, J.D. 2005. "State: Reviving teacher benefit plan will save money." *The Intelligencer*, June 21, 2005.

¹⁵ Consolidated Public Retirement Board & Buck Consultants, LLC. 2008. *Individual Voluntary Option for Members of the Teachers' Defined Contribution (DC) Retirement System to Transfer to the Teachers' Retirement System (TRS)*. Retirement Choice Decision Guide, CPRB.

¹⁶ Matthew Greenwald & Associates, Inc. 2004. *Retirement Plan Preferences Survey: Report of*

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¹⁷ Olleman, M.C. 2007. "Defined contribution experience in the public sector." *Benefits & Compensation Digest*, 44(2), 20-24.

¹⁸ Kabler, P. 2008. "State to save \$22 million in teacher pension switch." *Charleston Gazette*. August 26, 2008.

¹⁹ Gabriel, Roeder, Smith, and Company. 2005. *New Mexico Educational Retirement Board: Defined Contribution Retirement Plan Study*. Dallas, TX: Gabriel, Roeder, Smith, and Company.

²⁰ Wojcik, J. 2008. "Public entities generally keep traditional pension plans." *Business Insurance*. August 12, 2008.

²¹ Gabriel, Roeder, Smith, and Company. 2007. *Projections of ERSRI with Frozen Participation*. Irving, TX: Gabriel, Roeder, Smith, and Company.

²² Gabriel, Roeder, Smith, and Company. 2005. *New Mexico Educational Retirement Board: Defined Contribution Retirement Plan Study*. Dallas, TX: Gabriel, Roeder, Smith, and Company.