Klausner & Kaufman Conference

PENSION REDESIGN DOESN'T HAVE TO BE SCARY!

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1. **Public Pension Environment**
2. Principles of Public Plan Retirement Security
3. Trends in Public Retirement Plan Redesign
4. Defined Benefit Risk and Features
5. Plan Design Alternatives & Considerations
6. Case Study: The Redesign Process
7. Trustee Check List

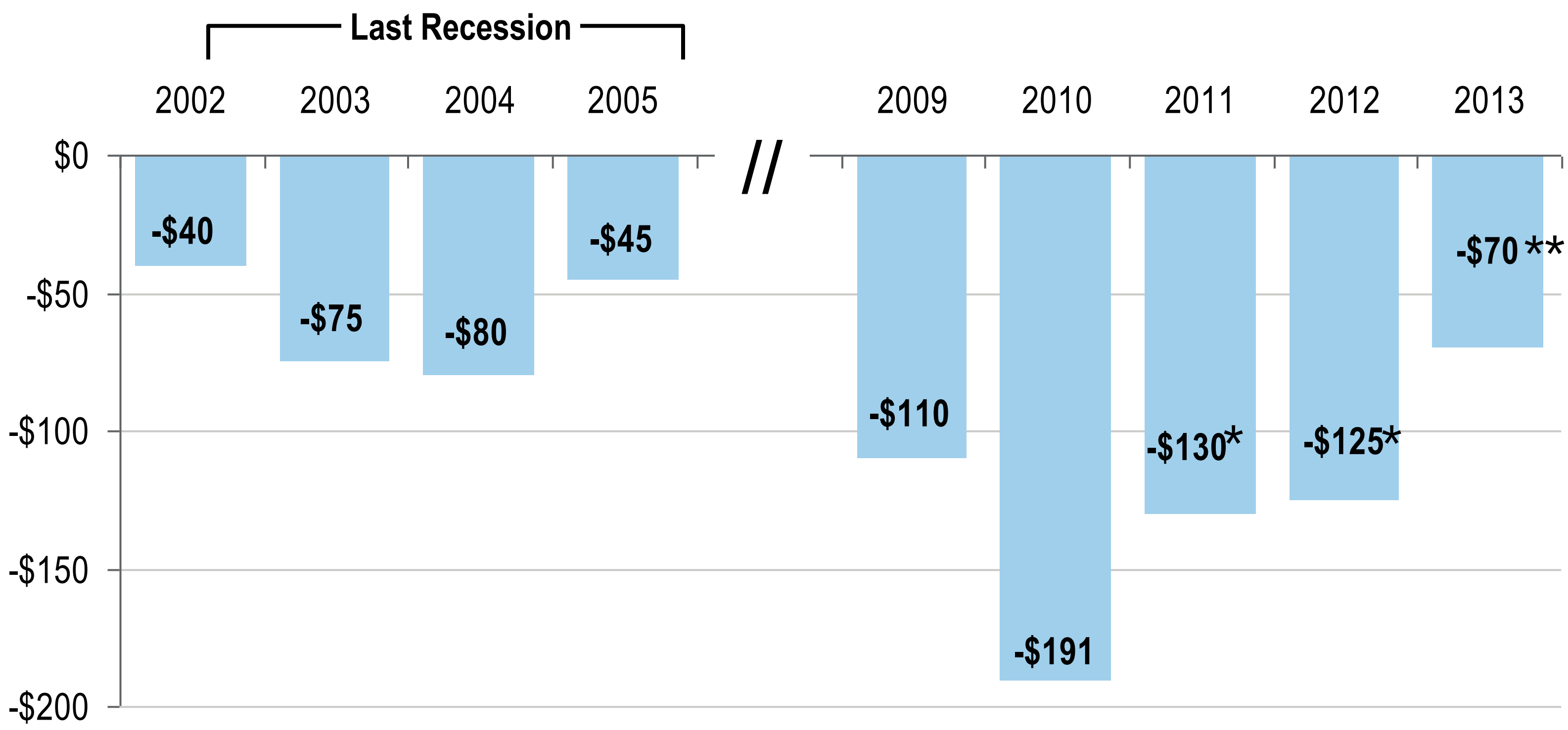
Public Pension Environment

1. **State and Local Government Budget Shortfalls**
   - Federal money going away
   - Ripe for “downsizing” agenda
   - Structure change
   - Rush to change
2. **More Conservative State Legislatures**
   - Limited experience with defined benefit plans
   - Term limits—no experience with government
3. **Federal Activity**
   - SEC New Jersey settlement
   - Public Employee Pension Transparency Act
   - Bankruptcy controversy
4. **Public Opinion**
   - Job/Pension/Health Benefit Envy
   - Confusion about benefit levels and cost
   - Perceptions of public workforce
5. **GASB Proposed Changes**
   - Determining liabilities
   - Reporting vs. funding

Public Pension Environment *continued*

State Fiscal Condition: How bad is it?

Total state budget shortfall in each fiscal year, in billions



* Reported to date.
** Preliminary.
Source: Center on Budget and Policy Priorities (2011). *States Continue to Feel Recession's Impact*

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Public Pension Environment *continued*

Fiscal Stress Measures: What Trustees Should Know

- Ratio of Required Contributions to the Total Budget of the Sponsoring Entity
- Required Contributions as a Percentage of Payroll
- Ratio of Market Value of Assets to Total General Fund Revenue of the Sponsoring Entity
- Ratio of Unfunded Actuarial Accrued Liability (UAAL) to Sponsoring Jurisdiction Population (UAAL per Capita)
- Ratio of Annual Required Contribution (ARC) to Sponsoring Jurisdiction Population (ARC per Capita)

Why should you care?

Public Pension Environment *continued*

Media and…

- Print
- TV/Cable News
- Internet—Blogs
- Opinion Research
  - Pew Center
  - Manhattan Institute
  - Rauh—Kellogg
  - National Institute for Retirement Security
- Center on Budget and Policy Priorities
- Center for State & Local Government Excellence

Principles of Retirement Security

S Stable Contributions

E Equalize Risk

C Committed Funding

U Universal Coverage

R Replace Adequate Income

E Efficient and Transparent Governance

If time allowed, would cooler heads prevail?

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Plan Redesign: Trends

Combined Plan	A dual plan is an arrangement which consists of both a defined contribution and defined benefit plan. The defined benefit is the primary plan while the defined contribution plan establishes a minimum benefit and provides portability
Cash Balance Plan	A cash balance plan is a defined benefit plan which looks like a defined contribution plan. Hypothetical account balances are credited annually with a percent of salary and a pre-defined interest crediting rate. The interest crediting rate is based on an index (e.g., one-year Treasury rate plus 1.5%) as defined in the plan. A simple example of a cash balance plan is one that allocates 5% of annual salary to each participant's cash balance account and guarantees a fixed rate of interest on those contributions.
Defined Contribution Plan	A defined contribution plan is a retirement savings arrangement to which employees contribute on a tax-deferred basis through a payroll deduction. Employers may provide a matching contribution. The retirement benefits are based on the accumulated contribution plus or minus investment returns and administrative fees. The employee bears all investment risk and typically can take the benefit as a lump sum.

Continuum of Public Retirement Plan Redesign

Defined Benefit	Combined Plans	Cash Balance	Defined Contribution
• Retention of defined benefit plan with changes for new hires: – Raise retirement eligibility – Raise contributions – Lower multiplier – Reduced or suspended COLA – Eliminate rehired retirees and spiking • Some states/localities have reduced COLA for existing retirees • Some states/localities are considering changes for future accruals for current active employees	**Washington** • Employee choice of: – Plan 2: DB–2% of pay plan – Plan 3: » DB–1% of pay plan » DC Employer contribution: 8% Employee contribution: 5% – 15% **Oregon** • Combined DB/DC plan • Tier II: – DB 1.5% of pay plan employer funded – DC 6% employee funded **Utah** (July 2011) Employee Choice of: • Tier II: – DB 1.5% of pay plan – 10% cap on employer contributions • DC funded by “excess” employer contributions OR • DC 10% employer contributions	**Nebraska** (January 1, 2003) • Employees contribution: 4.8% • Employer contribution: 7.5% • Investment return guarantee: – At least 5% annual return – Potential for additional Board approved amount – Total not to exceed 8%	**Alaska** (July 1, 2006) • All new employees • Employer contribution: 3.5% plus 3.75% to retiree health fund • Employee contribution: 8% **Michigan** (March 1997) State Employees: • Employer contribution: 4% up to 7% • Employee contribution: up to 3%

There are many choices for redesign.

Proposed Guaranteed Retirement Account (GRA)
National Defined Contribution Plan

- Proposed mandatory Federal savings program, unless workers participate in an equivalent or better employer defined benefit plan, with contributions of at least 5% that provide an annuity benefit
- GRAs would be 401(k)-like individual saving accounts where the Federal government invests and manages the assets (Social Security Administration/Federal Thrift Savings Plan)
- The federal government would subsidize each account with an annual $600 tax-credit (paid for by eliminating the tax-deferred treatment of 401(k)s and IRAs)
- Workers and employers would share a 5% contribution (up to the Social Security cap), both can make additional post-tax contributions

Proposed Guaranteed Retirement Account (GRA)
National Defined Contribution Plan continued

- The Federal government would pay a guaranteed 3% real rate of return
- Retirement age tied to Social Security ages with exceptions for disability or death
- Combined with Social Security the average replacement would be 70% of pre-retirement earnings
  - Based on employee earning $40,000 and working 40 years
  - GSA portion replaces 26% of pre-retirement earnings
- Benefit is in the form of a inflation-indexed annuity
- Success of proposed GSA dependent on strong Social Security system

Benefit Changes
Summary of Recent Plan Changes

		Change	Approach
Contribution Rates	Employer	CA, CO,FL, IA, LA, MN, NJ, NM	• Raise contribution rates • Lower contribution rates
	Employee	CO, IA,, LA, MN, MO, MS, VA, VT, WY	• Raise Contributions • Mandate contributions
COLA	New Hires	CO, IL, MI, MN, SD, UT, VA	• Suspension tied to funding or CPI • Tied to funding percentage • Delay start
	Actives	CO, MN, SD	
	Retirees	CO, MD, MN, SD	
Sponsor Contribution Rules		IA, NJ, VA, VT	• Additional contributions to ARC • Require ARC
Anti-Spiking		AZ, CO, IA, IL, NJ, VA	• Pensionable compensation • Longer FAS period • Longer vesting periods • Cap compensation growth in FAS period
Multiplier	New Hires	GA, NJ	• Lower multiplier • Reduce longevity multiplier
	Actives	VT	
Retirement Eligibility	New Hires	IL, MN, MO, MS	• Raise service requirements • Eliminate combined age/service rule • Increase combined age/service rule
	Actives	AZ, CO	
Retirement Age	New Hires	MO	• Raise normal retirement age • Coordinate with social security normal retirement age
	Actives	AZ, CO, VT	
Re-employment		CO, GA, IL, MI, MS, NM, SD, UT	• Eliminate service accrual after rehire • Suspend pension and health benefits based on earnings after rehire
Hybrid	New Hires	GA, MI, UT	• Combine Defined Benefit plan with a lower multiplier with Defined Contribution overlay • Choice of hybrid or Defined Contribution
Defined Contribution	New Hires	NJ, UT	• Part-time workers • Elected officials provided an employer match

Source: National Conference of State Legislatures, July 2010

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Risk and Features of Different Defined Benefit Plans

Defined Benefits Plan Designs

Type	Description	Example	Variations	Pros	Cons
1. Final Average Earnings (FAE)	Benefit based on a percentage of participant's average earnings during specified period	1.5% x Final 5-year Average Earning x Years of Service	May limit service or salary; Overall dollar limit	Benefit linked to salary growth; Keeps pace with Inflation	Back-loaded accrual/cost pattern
2. Career Average Earnings (CAE)	Benefit based on percentage of participant's average earnings over career	1.5% x Career Average Earning x Years of Service	May include inflation update; Layered accruals are common	Benefit partially linked to salary growth; Level accrual/cost pattern w/o updates	Does not keep pace with inflation; Increased administration
3. Flat Dollar	Benefit based on stated amount for each year of service	$60 x Years of Service	May include inflation update; May limit service	Simplicity; Uniformity; Level accrual/cost pattern w/o updates	Benefit not linked to salary growth; Does not keep pace with inflation
4. Hybrid Plan (i.e., Cash Balance)	Benefit based on account balance that can be converted to annuity at retirement; Account balance determined similar to DC Plan	7.5% of annual earnings contributed to account; account balance grows 5% per year for interest	Contribution may vary by age/service	Benefit partially linked to salary growth; Keeps pace with inflation; Benefit defined in terms of account balance	Lack of familiarity; Administrative complexity

Risk and Features of Different Retirement Plan

Employer and Employee Risk of Different Designs

	Defined Benefit										Defined Contribution	
	Flat Dollar		Career Average		Final Average		Hybrid		Lump Sum Options		401(a), 401(k), 403(b)	
	ER	EE	ER	EE	ER	EE	ER	EE	ER	EE	ER	EE
Economic Risks												
Investment Risk	4	1	4	1	4	1	3	2	3	3	0	4
Inflation risk	0	4	1	3	3	2	2	2	2	2	1	3
Contribution Risk	3	1	4	1	4	1	3	1	3	1	1	1
Longevity Risk	4	0	4	0	4	0	3	2	3	4	0	4
Non-Economic Risks												
Accounting Risk	3	0	3	0	3	0	3	0	3	0	0	0
Features												
Rewards older/longer service employees	4		3		3		2		2		1	
Planning Tool	2		2		2		1		1		1	
Hiring Attractiveness	2		2		2		3		3		3	

Risks	Features
0 None	Not applicable
1 Low	Minor importance
2 Somewhat low	Somewhat minor importance
3 Somewhat high	Relatively important
4 High	Very Important

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Potential Benefit Alternatives

Defined Benefit Changes

Larger Impact on Cost Savings

- Retirement eligibility
- Cost of living adjustments (COLAs)
- Benefit formula
- Increase in member contribution rates

Smaller Impact on Cost Savings

- Anti-spiking
- Re-employment
- Final average salary period
- Cost of purchased service

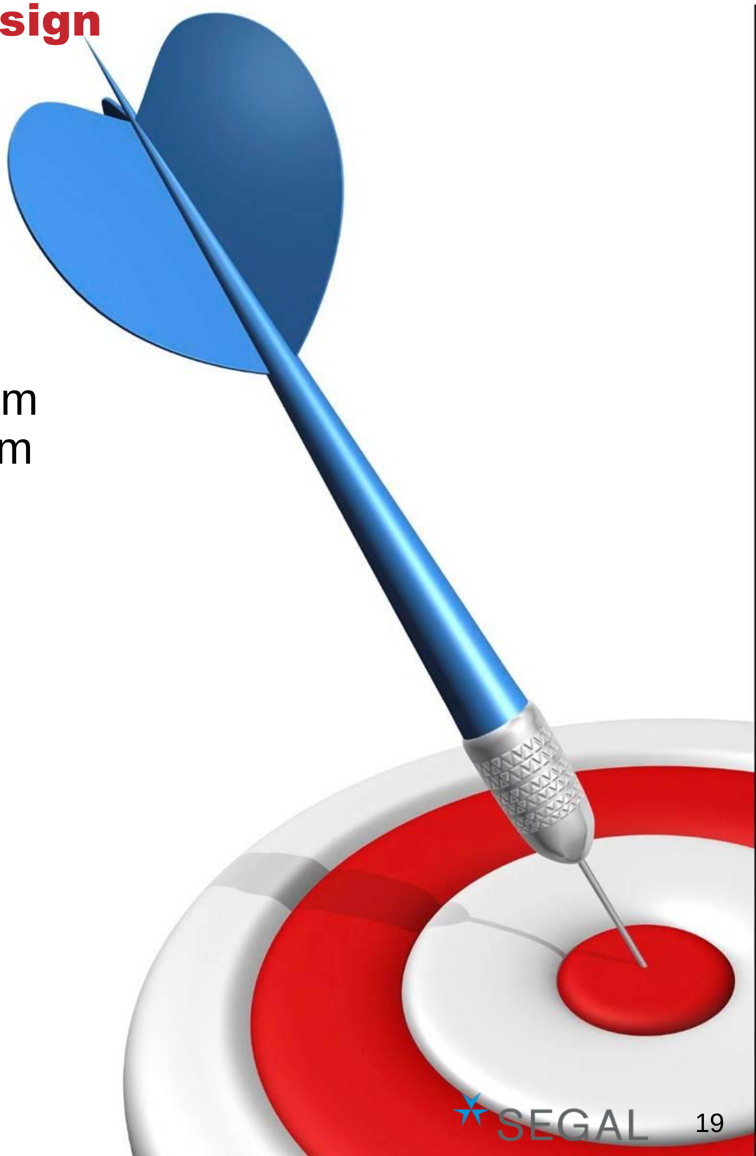
Alternative Plan Designs

- Changes to defined benefit plan
- Hybrid plans
- Defined contribution plans

Plan Design Considerations

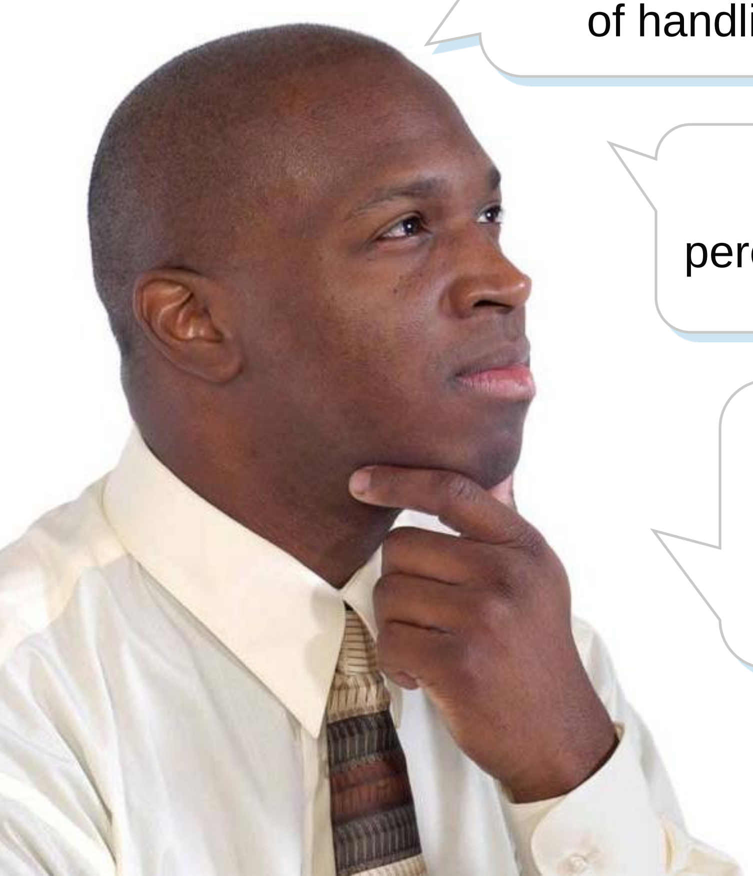
Assessing the Appropriateness of a Plan Design

- Assess risk components
  - Is risk in its proper place?
  - Can the risk be managed by the State or Locality?
    - Investment risk
    - Longevity risk
    - Short-term vs. long-term benefit risk (Is a short-term problem being solved at the expense of a long-term problem?)
- Measure against retirement philosophy
  - Adequacy at retirement (replacement ratios)
  - Purchasing power into retirement
- Measure against funding policy
  - Stability
  - Amount
- Analyze investment options
  - Sufficient number and variety
  - Sufficient safeguards



Plan Design Considerations *continued*

Considerations in Selecting the "Right" Plan



How do we mitigate financial risk? Are employees capable of handling risk?

Who am I competing with for talent? Will that change? What are they doing?

How do I balance perceived and real value?

What are my future talent requirements? What type of retirement programs supports those needs?

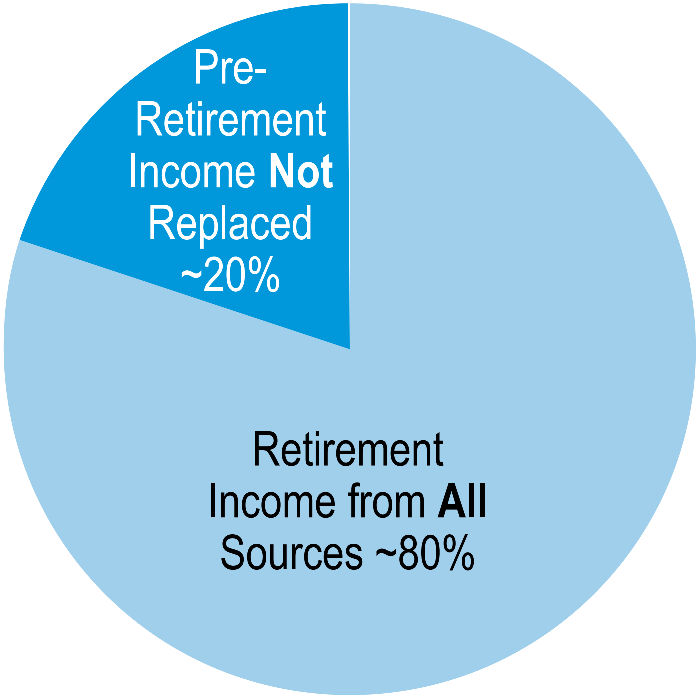
Are benefits—and in particular retirement benefits—important in attracting and retaining employees?

Is adequacy of retirement income an issue?

Plan Design Considerations *continued*

Retirement Income Replacement Ratios

- A common approach used to analyze and compare retirement programs is to measure the relative income provided by the retirement plan as a percentage of the employee's final salary prior to retirement.
- Retirement Income Replacement Ratio ("Replacement Ratio")—measure of annual income provided at retirement to the employee's final salary prior to retirement
  - Includes income from all sources including public employer-provided retirement benefits, Social Security and employee savings
- Employees need between 78% to 94% of pre-retirement income ("replacement ratio") to maintain their standard of living during retirement



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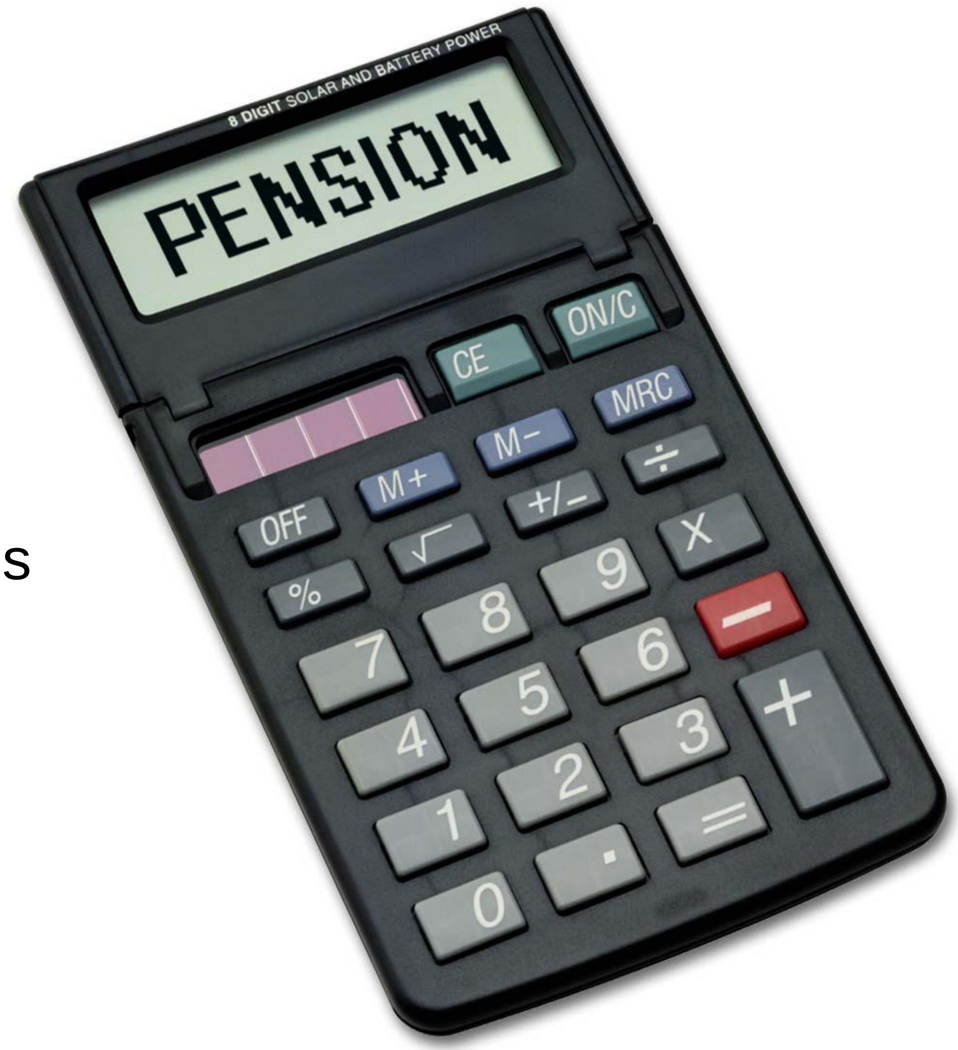
Case Study 1: Maintain DB Plan

- Maintain current DB Plan
- Make changes for future accruals



Relative Impact of Defined Benefit Plan Changes

- **Principles to consider—strike the right balance among:**
  - Budget constraints and reasonable annual funding
  - Responsible stewardship of plans
    - Reasonable actuarial assumptions and methods
  - Delivery of market-driven and affordable pension benefits
  - Recognize constitutional and contractual obligations of the State or locality to its employees
  - Need for constituent buy-in

- **Level of contributions needed to support existing plans in current form may not be sustainable.** A long-term solution will require focus on all four levers:
  1. Employer contributions
  2. Benefits
  3. Employee contributions
  4. Investments

Relative Impact of Defined Benefit Plan Changes *continued*

Boulders, Rocks, Pebbles, Sand

There are numerous benefit changes that would reduce cost, but by how much?

This is a way of prioritizing/ranking changes based on their impact to the ARC.

Boulders
Substantial Reduction in ARC—more than 20%

Rocks
Large Reduction in ARC—at least 10%

Pebbles
Small Reduction in ARC—about 5%

Sand
Minimal Reduction in ARC—less than 5%

Impact on ARC is estimated

Benefit Changes to Consider

- COLA
- Retirement Age
- Benefit Formula
- Purchase of Service
- Other

Relative Impact of Defined Benefit Plan Changes

Types of potential changes—will likely require legislative approval

Boulders

- Fund 100% of the Annual Required Contribution
- Eliminate the COLA
- Deliver future pension benefits under a new plan structure with shared risk
- Change to a career average pension plan
- Change to a cash balance pension plan

Rocks

- Modify the COLA
- Increase minimum retirement age for unreduced benefits
- Add minimum retirement age for early retirement benefits
- For current active employees in current plan, change benefit formula for future service
- Increase employee contribution rate

Relative Impact of Defined Benefit Plan Changes *continued*

Types of potential changes—will likely require legislative approval

Pebbles and Sand

- Increase final average salary period from 3 or 5 years to 5 or 7 years
- Modify purchase of service benefits
- Eliminate interest on member accounts
- Eliminate the loan provisions
- Reduce disability and death benefits
- Prohibit pay spiking

Case Study 2: Implement DC Plan for New Hires

- Maintain current DB plan for existing members
- Implement DC Plan for new hires

Defined Benefit versus Defined Contribution

- Under a DB plan, the benefit is defined and the contribution is not
- Under a DC plan, the contribution is fixed, but the benefit is not
- Plan risks:
  - Investment Risk
  - Demographic Risk
  - Post-retirement Cost-of-Living Risk
  - Longevity Risk
- In a DB plan, the employer bears these risks
- In a DC plan the employee bears these risks

DC Plan Benefit Adequacy

Investment Return/Expense

- Professionally managed DB plans earn approximately 1% per year more than individually managed DC plans
- Investment expenses are typically 0.5% more for DC plans
- As a result, with equal contributions a DB plan will most likely provide for greater benefits at retirement than a DC plan

Leakage

- Studies have shown that much of the money in DC plans is spent prior to retirement

Supplemental Benefits

- A DC plan death or disability benefit is the account balance
- Death benefits and disability benefits would need to be provided outside the DC plan to be comparable to what the DB plan currently provides

Employer Issues

- DB plans are used to attract and retain employees:
  - Critics believe the public sector benefits are too generous and that public sector salaries have caught up to the private sector
  - However when considering education and training, a recent study found that public sector compensation (including pensions) trail the private sector by about 7%
- DC plans cannot be structured to help retain employees beyond once contributions become vested:
  - The current DB plan helps public employers attract workers and retain them through their productive years
  - DC plans may attract young workers, but once they are trained and their contributions are vested, there is no incentive to continue employment
  - A DC plan could lead to higher turnover and higher training costs for employers

Employee Issues

- Employees assume more risk in a DC plan:
  - **Investment Risk**
    - DC plans earn less returns on average than DB plans
    - DC members must make up investment losses with additional contributions or (if already retired) with lower distributions
  - **Demographic Risk**
    - DC members who retire earlier than expected or become disabled will have less retirement income than expected
  - **Post-retirement Cost-of-living Risk**
    - DC plans have no mechanism to provide post-retirement benefit increases
    - DC retirees must properly manage their assets to allow for increases in their cost-of-living expenses
  - **Longevity Risk**
    - DC retirees must ensure they do not outlive their assets

Administrative Issues

- Implementing a a DC plan would mean the entity would have another plan to administer

- Additional administrative tasks include:
  - **Establish Administration**
    - Could be administered internally or externally
    - If internal, determine staffing and system requirements
  - **Plan Governance**
    - Form governing committee
    - Adopt investment policies
    - Determine investment options to be offered
  - **Employee Education**
    - Establish responsibility for initial education
    - Determine the type of information that will be provided
    - Determine the necessary ongoing reports or training
    - Determine how often the educational tools will be updated

Actuarial Determined Contribution Rates as of July 1, 2010

Currently, the DB plan is funded assuming the payroll of the active members will continue to increase. If the plan were closed and the UAAL were funded over the declining payroll, the actuarially determined contribution rates would increase.

	Current Plan	Closed DB Plan
Regular Employees • Employer-Pay	24%	35%
Police/Fire Employees • Employer-Pay	40%	52%

Conclusions

- Implementation of a DC plan should be carefully considered
- Shifting the risks to employees could result in workforce recruitment and retention issues
- The cost of the DB plan will increase significantly, as a percent of DB payroll, if a DC plan is established for new hires
- A DC plan may not provide employees with adequate retirement benefits
- The administration of a DC plan presents a number of challenges and costs
- Consideration should be given to the impact of a DC plan on public safety employees

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Trustee Checklist

- ✓ Be knowledgeable of your entity's fiscal condition
- ✓ Understand national financial, market, and economic environments and how they impact the pension system
- ✓ Determine principles **S-E-C-U-R-E**
- ✓ Understand optimal designs
- ✓ Consider long term impact of benefit changes on costs, benefit levels, recruitment, and retention

Have courage


Questions

Thank You!

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