# Redefining Traditional Plans: Variations and Developments in Public Employee Retirement Plan Design

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**Keith Brainard**
**National Association of State Retirement Administrators**

# Expressions of Retirement Plan Design

**"We should favor pension contracts that have both individual capital accumulation and annuitization elements."**

Peter Drucker, 1976

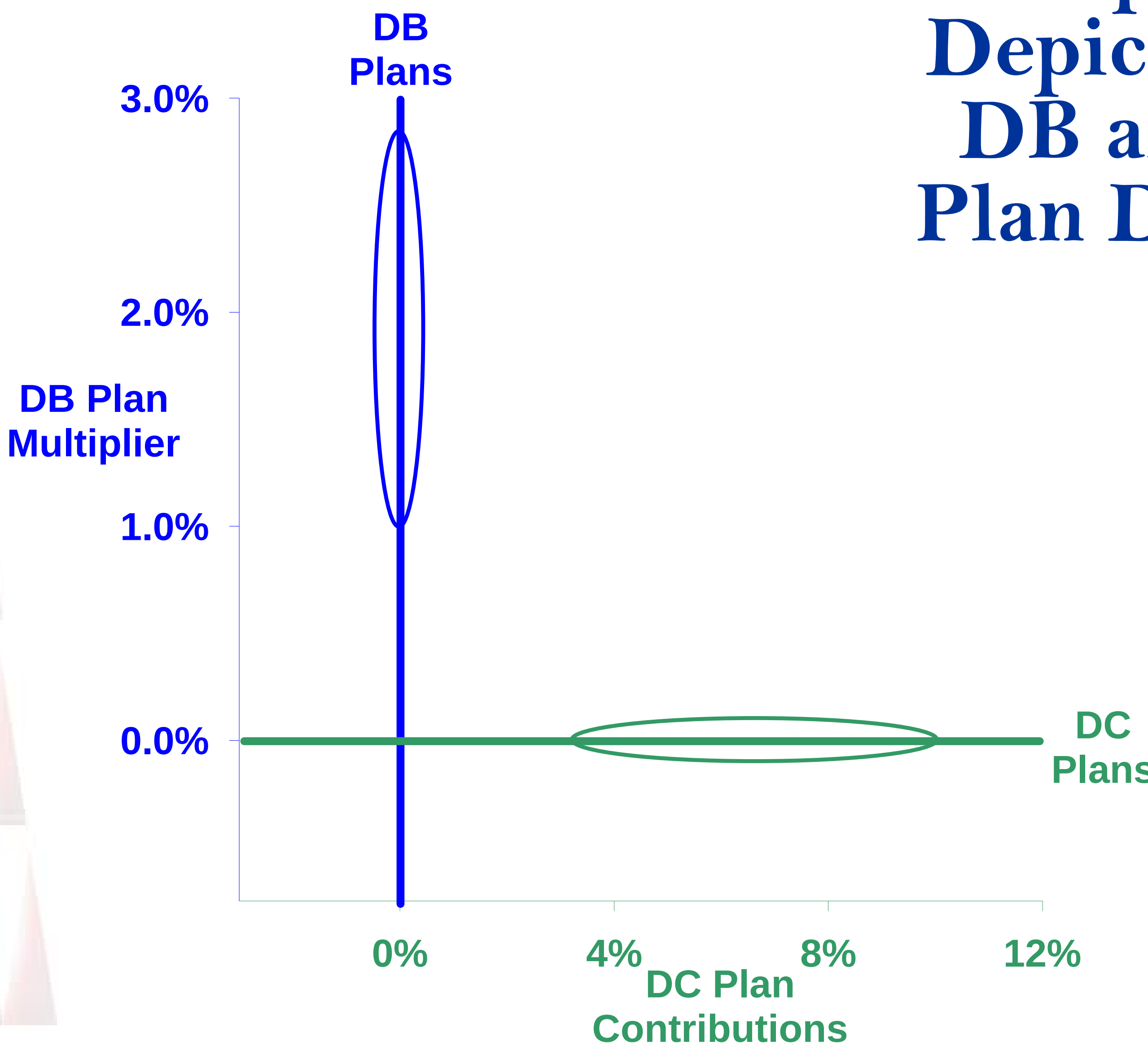
**"DC plans should adopt automatic enrollment, automatic deferral increases, lifecycle funds as default options, annuity and guaranteed income options, and investment advice."**

Abby Johnson, 2006 (paraphrased)

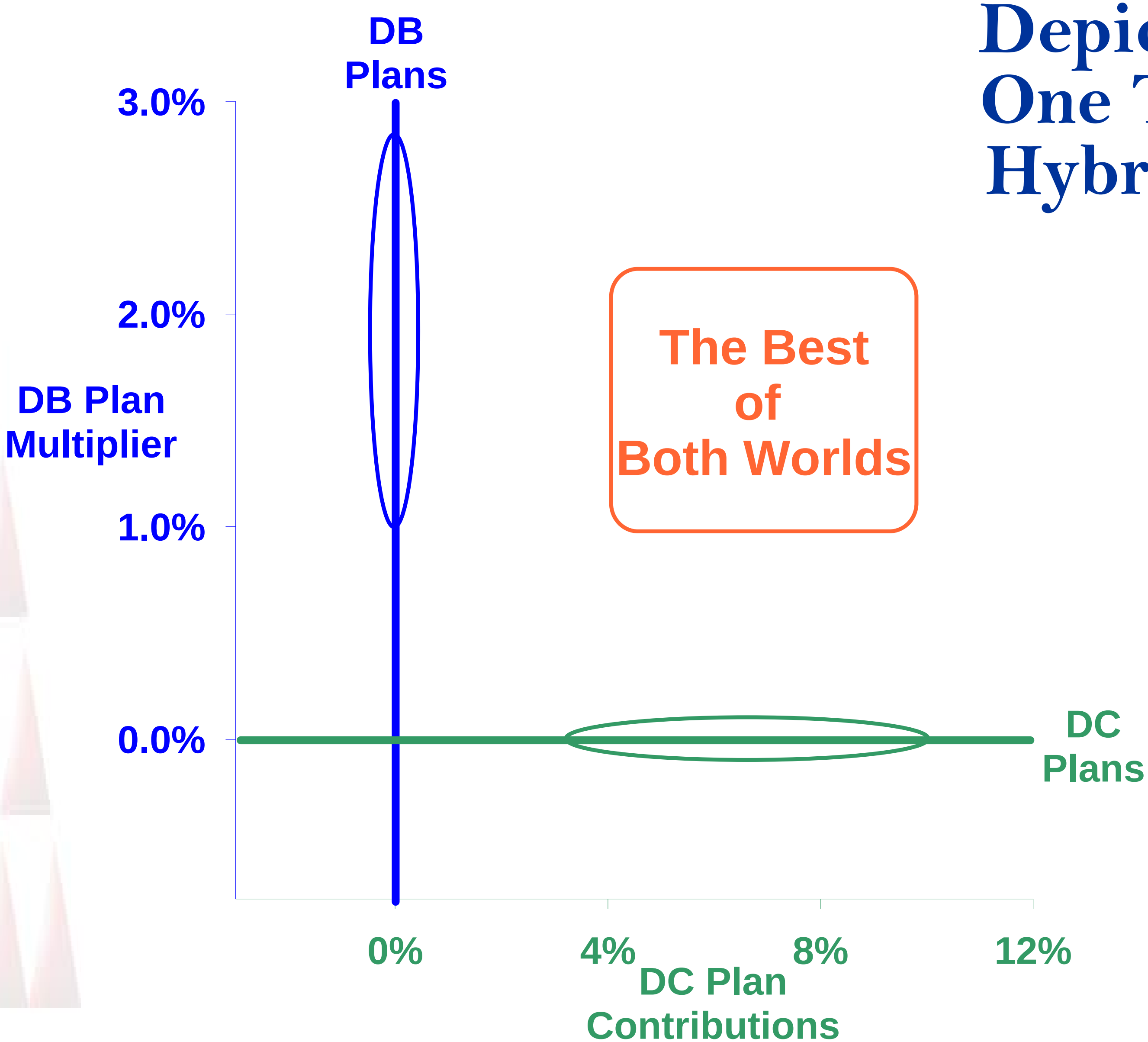
**"The pendulum always swings a little too far. [Pension plan design] doesn't have to be an all-or-nothing proposition."**

Bradley Belt, 2007

# Simplified Depiction of DB and DC Plan Designs



# Simplified Depiction of One Type of Hybrid Plan



# Retirement benefits should and can meet stakeholder objectives

- Who are the primary stakeholders of public retirement benefits?
  - Public employers
  - Public employees
  - Taxpayers
  - Recipients of public services
- Stakeholder objectives can be met by employing the best features of all plan types.

# Plan designs discussed in this paper

- Cash balance plan for state and county workers in Nebraska
- Earnings limitation savings accounts at the Minnesota Teachers' Retirement Association
- Investment earnings-based COLA at the Arizona State Retirement System
- Deferred annuity benefit at the Minnesota statewide retirement systems
- Individual account plans at the Oregon Public Employees' Retirement System

# Variations in pension plan designs not discussed in this paper (but could have been)

- service purchase and transfer options
- partial lump sum options
- deferred retirement option plans
- auto-enrollment in supplementary DC plans
- cash balance plans in lieu of Social Security for part-time and seasonal workers

# Cash balance plan for state and county workers in Nebraska

**Objective:** Provide a benefit containing core DB plan elements at no additional cost relative to the legacy DC plan

- Nebraska state and county workers had only a DC plan until 2003
- A study found these workers were reaching retirement age financially unprepared

# Cash balance plan for state and county workers in Nebraska

- New CB plan includes new hires as of 1/1/03 and 30 percent of 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

- 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% | na | 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 |
| **AVG** | **5.61** | **4.33** | **9.95** |

# Cash balance plan for state and county workers in Nebraska

- Normal retirement: age 55 with 3 years of svc
- Postponing retirement increases benefits by 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

# Earnings Limitation Savings Accounts (ELSAs) at the Minnesota Teachers' Retirement Association

## Objectives

1. Eliminate disincentives for retired public school teachers to return to work;
2. facilitate employers' needs for qualified teachers;
3. comply with IRS regulations governing in-service distributions;
4. remain cost-neutral.

# Factors driving "return-to-work" among retirees

- Increasing retirement rate
- Growing worker shortages, especially among teachers and certain other worker groups
- Changing perceptions of retirement and work
- Need for additional income
- Rising health care costs

# Earnings Limitation Savings Accounts (ELSAs) at the Minnesota Teachers' Retirement Association

- Return-to-work is a challenge for plan sponsors, employers and retirement systems, who must remain compliant with IRS rules forbidding in-service distributions
- Many states limit the amount of time a rehired retiree can work or require retirees to "sit out" for a defined period of time, e.g., three months or one year

# ELSAs at the MN TRA

- Pension benefits for Minnesota retired teachers who return to work are deposited into an individual account earning a nominal interest rate
- Account becomes accessible as a lump sum at age 65
- This plan feature complies with IRS regulations
- Avoids negative public perceptions of "double-dipping"
- Creates a DC plan-like lump sum
- Reduces the incentive to retire for purpose of getting both a paycheck and a pension benefit

# Investment Earnings-Based Permanent Benefit Increase at the Arizona State Retirement System

**Objective:** Reduce the effects of inflation on retirement benefits without creating an unfunded liability

- Automatic cost-of-living adjustments are an inflation hedge, but they also are expensive
- Initiating an auto-COLA can result in shifting costs to future participants and taxpayers
- Automatic COLAs usually are disconnected from the economic condition facing active participants and employers

# Investment Earnings-Based Permanent Benefit Increase at the Arizona State Retirement System

- ASRS active participants and employers make matching contributions, based on actuarial experience
- The investment-based PBI enables retired members to share, with actives and employers, in rising markets and to share the pain in periods of poor market returns
- The PBI pays a permanent benefit increase to current retirees based on investment returns above the actuarial assumption of 8.0 percent, smoothed over 10 years
- Maximum annual increase is 4.0 percent; avg benefit 1994 to 2005 was 3.30 percent, more than inflation
- Benefit is based on service, not the size of the benefit, which benefits longer-tenured workers

# Deferred Annuity Benefit at the Minnesota statewide retirement systems

**Objective:** Reduce the effects of inflation on the value of retirement assets for participants who terminate before qualifying for retirement

- This plan design feature addresses the issue of turnover in a DB plan
- Turnover typically creates an actuarial gain for the plan and often results in leakage of retirement assets

# Deferred Annuity Benefit at the Minnesota statewide retirement systems

- Terminating DB plan participants who retain their assets with the plan face inflation risk
- The deferred annuity benefit reduces the effect of inflation by increasing the value of the benefit by 2.5 percent annually from termination
- Retirement fund forgoes actuarial gain from terminating participants, but preserves retirement assets that might otherwise be lost

# Individual Account Plan sponsored by the Oregon PERS

## Objectives

1. Restore DB plan cost sustainability
2. Allow both plan sponsors and participants to share investment risk
3. Give participants access to a lump sum
4. Preserve annuitized benefits.

# Individual Account Plan sponsored by the Oregon PERS

- In response to a declining funding situation, the Oregon Legislature established a new hybrid plan:
  - Traditional DB plan with a reduced multiplier of 1.5 percent
  - Mandatory participation in the IAP, which is a DC plan
  - IAP contributions go to individual accounts invested in the same manner as the DB fund

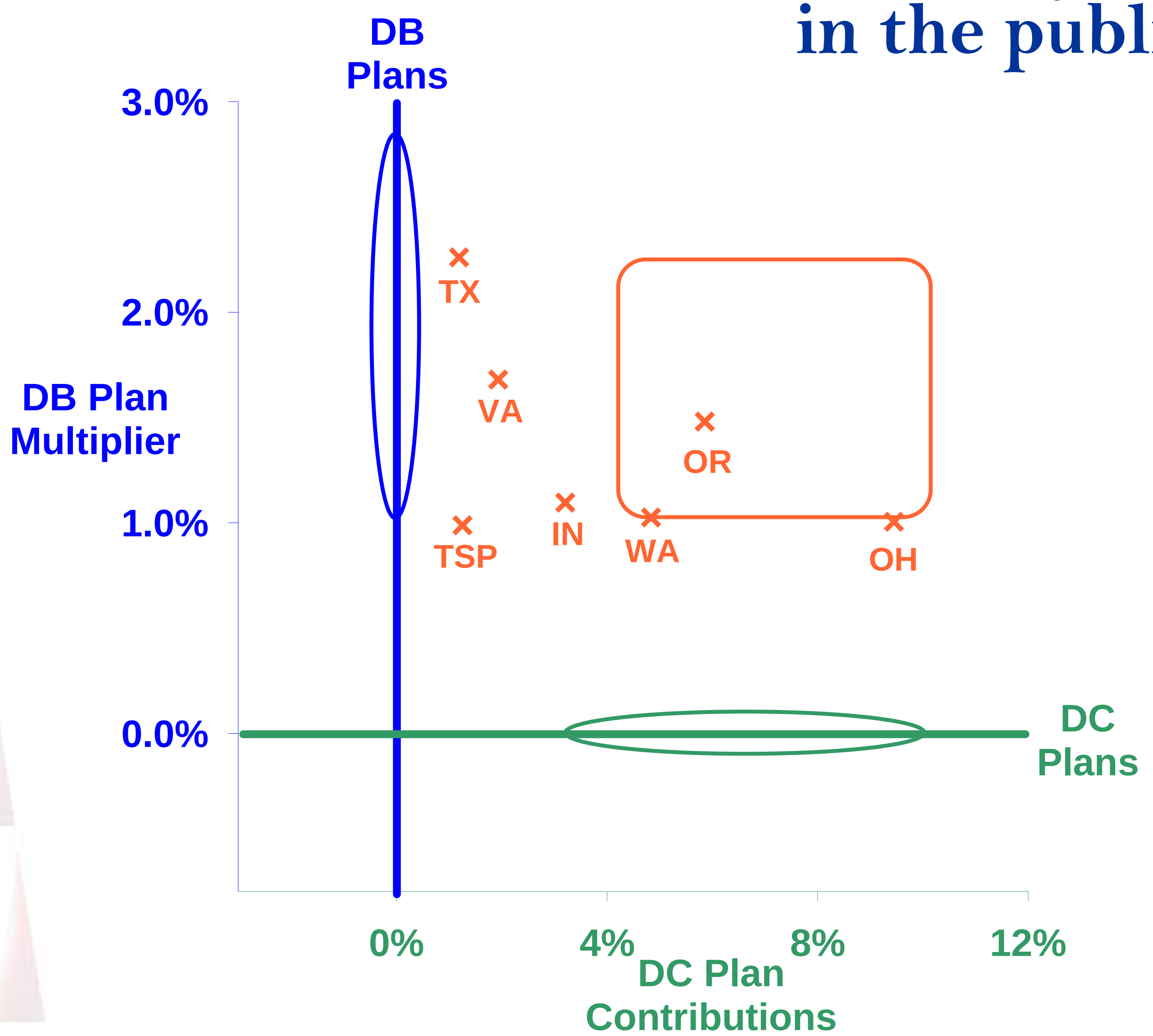
# Individual Account Plan sponsored by the Oregon PERS

- IAP assets are professionally invested at a low cost in a diversified portfolio
- 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 have been credited an average of 12.51 percent from 2004 to 2007
- DB plan's funding level has returned to nearly 100 percent and contribution rates have declined dramatically
- Other states, including Washington, Ohio, Indiana, and Georgia for new hires as of 1/1/09, have similar plan designs

# Some hybrid plans in the public sector



| | Indiana PERF | Indiana TRF | Washington DRS | Ohio PERS | Ohio STRS | Oregon PERS |
|---|---|---|---|---|---|---|
| **Applicable group(s)** | Mandatory for all participants | Mandatory for all participants | Optional | Optional for new hires and non-vested workers since 2002 | Optional for new hires and non-vested workers since 2001 | Mandatory for new hires since August 2003 |
| **Normal retirement age/yrs of service** | 65/10, 60/15, Rule of 85 at age 55 | 65/10, 60/15, Rule of 85 at age 55 | 65/5 | 60/5, 55/25, any/30; 48/25 for law enforcement | 60/5 | 65/any, 58/30; 60/any, 53/25 for public safety |
| **DB plan multiplier** | 1.1% | 1.1% | 1.0% | 1.0%; 1.5% for years in excess of 30 | 1.0% | 1.5%; 1.8% for fire and police |
| **Employer funds DB plan benefit?** | Yes | Pre-'96 hires, no; new hires since, yes | Yes | Yes | Yes | Yes |
| **Social Security?** | Yes | Yes | Yes | No | No | Yes |
| **Employer contribution to DC plan** | Employers may elect to make EE contributions, which vest immediately. The State makes contributions for its employees. | Employers may elect to make employees' contributions, which vest immediately | No | ER contributions are divided among DB, DC, D&D and retiree health care. Five-year vesting period for ER contributions | ER contributions are divided among DB portion, DB UAAL, and retiree health care. 5-year vesting period for ER contributions | Employers may elect to make employees' contribution |
| **Employee DC plan contribution** | 3.0% | 3.0% | 5% to 15%, depending on EE election | 9.5%, including 0.1% for admin fees | 10.0% | 6.0% |