Retirement Plan Design

Much of What You Think You Know is Wrong

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Myths

- FAS Defined Benefit is ***not*** the most cost-efficient model.
- FAS Defined Benefit ***does not*** facilitate recruitment and retention better than other models.
- Moving to a different model ***does not*** result in large transition cost.
- The choice between retirement plan models is not just about who bears the risk or cost reduction.
- If the state moves away from FAS DB, it could continue to offer important protections for workers, including annuities and death and disability benefits.

Things We Can All Agree On

- Retirement compensation is an important and highly valued part of an employee's total compensation package.
- A lack of retirement security, just like general economic insecurity, harms both the individual and society.
- 401(k) is often implemented poorly in the private sector – lack of saving, high fees, poor asset allocation, under-annuitization.

Things We Can All Agree On

- The accumulation of pension debt by public employers has had negative consequences for workers – lower benefits, stagnant wages, fewer jobs.
- Creating a sustainable retirement savings system that offers retirement security, for both public and private sector workers, is an important public policy goal.

Retirement Plan Design Principles

- Retirement plans exist to provide workers with a savings vehicle that will put them on a path to retirement security.
- To achieve the goal of placing workers on a path to retirement security, plans provide protections on three dimensions:
  - Savings/benefit accrual rate
  - Investment allocation and earnings
  - Longevity

Retirement Plan Design Principles

- Protections on each of these dimensions can and should be incorporated in any primary retirement savings plan.
- In practice, many employers, both private and public sector, offer workers substantial protections on each of these three dimensions across a variety of plan types – including Defined Contribution.
- Retirement plan design does **not** run on a smooth continuum from FAS DB to DC where the former offers the most protection while the latter offers the least.

Retirement Plan Design Principles

- At a minimum, all primary retirement savings plans should satisfy design principles in two primary areas:
  - **Retirement Security** - All workers should be placed on a path to a secure retirement regardless of tenure or when they were hired.
  - **Sustainability** - Retirement savings plans must be designed to be sustainable in the long-term.

Retirement Plan Design Principles

- **Retirement Security**
  - **Retirement Savings** – Contribution and benefit accrual rates for the plan should be adequate across an employee's entire career.
  - **Professionally Managed, Low-Fee Investments** – Employees should have access only to professionally managed, low-fee investment options with appropriate asset allocation.
  - **Annuities** – Employees should have access to lifetime income options upon retirement.

Retirement Plan Design Principles

- **Sustainability**
  - **Pay for Retirement Promises** – Plan sponsors must pay for their retirement promises in a responsible, sustainable way.
  - **Plan for Uncertainty** – Plan sponsors must be informed about the potential for and have an ex ante plan to deal with cost/benefit uncertainty.
  - **Governance** – Retirement plan governance should appropriately balance the interests of all parties and, above all, ensure the long-term sustainability of the plan.

Retirement Plan Design Principles

- **Simplicity** and **Transparency** should be the watchwords of plan design.
- Plan sponsors should strive to offer a retirement benefit that is easy to understand both in terms of the benefits earned by employees and the cost of those benefits.
- Complexity is a four-letter word in public policy, meaning that unnecessary complicity causes real management difficulty and economic cost.

FAS DB

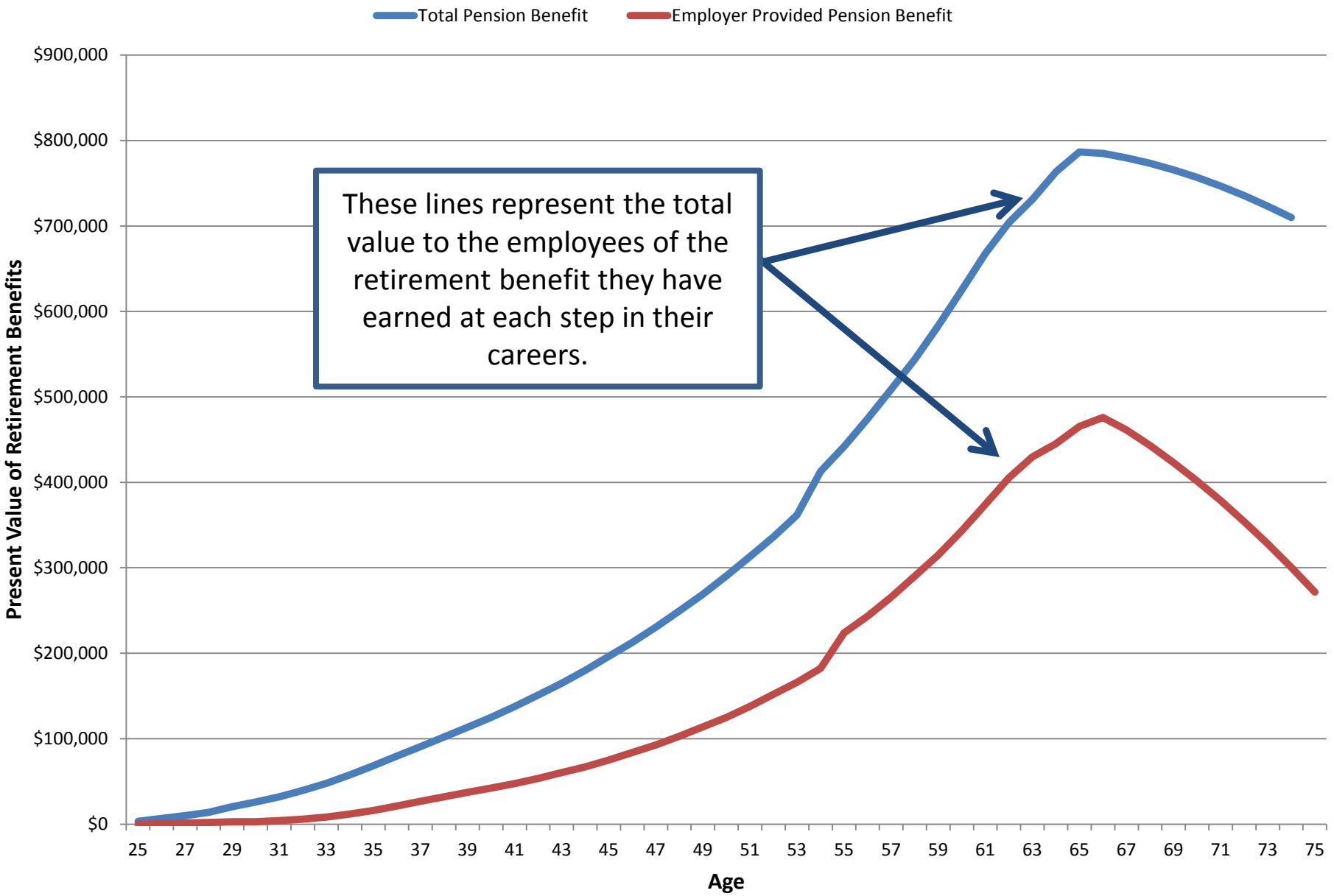
- Retirement Security
  - FAS DB has historically provided access to professional, low-fee investment management with appropriate asset allocation.
  - FAS DB provides access to annuities.
  - FAS DB often fails to provide all workers regardless of tenure or when they were hired with benefit accumulation rates that place them on a path to a secure retirement.

FAS DB

- Benefits are backloaded, meaning that workers accrue most of their retirement benefit in their last few years of work.
- Backloaded benefits can leave employees on a retirement-insecure savings path through much of their careers.
- The benefit structure also creates strong financial and psychological incentives in the years around retirement eligibility thresholds.
- Benefits disproportionately reward those who enter the workforce later and who move into highly paid jobs.

Current TRA Benefits

(25-year old entrant, adjusted for inflation)



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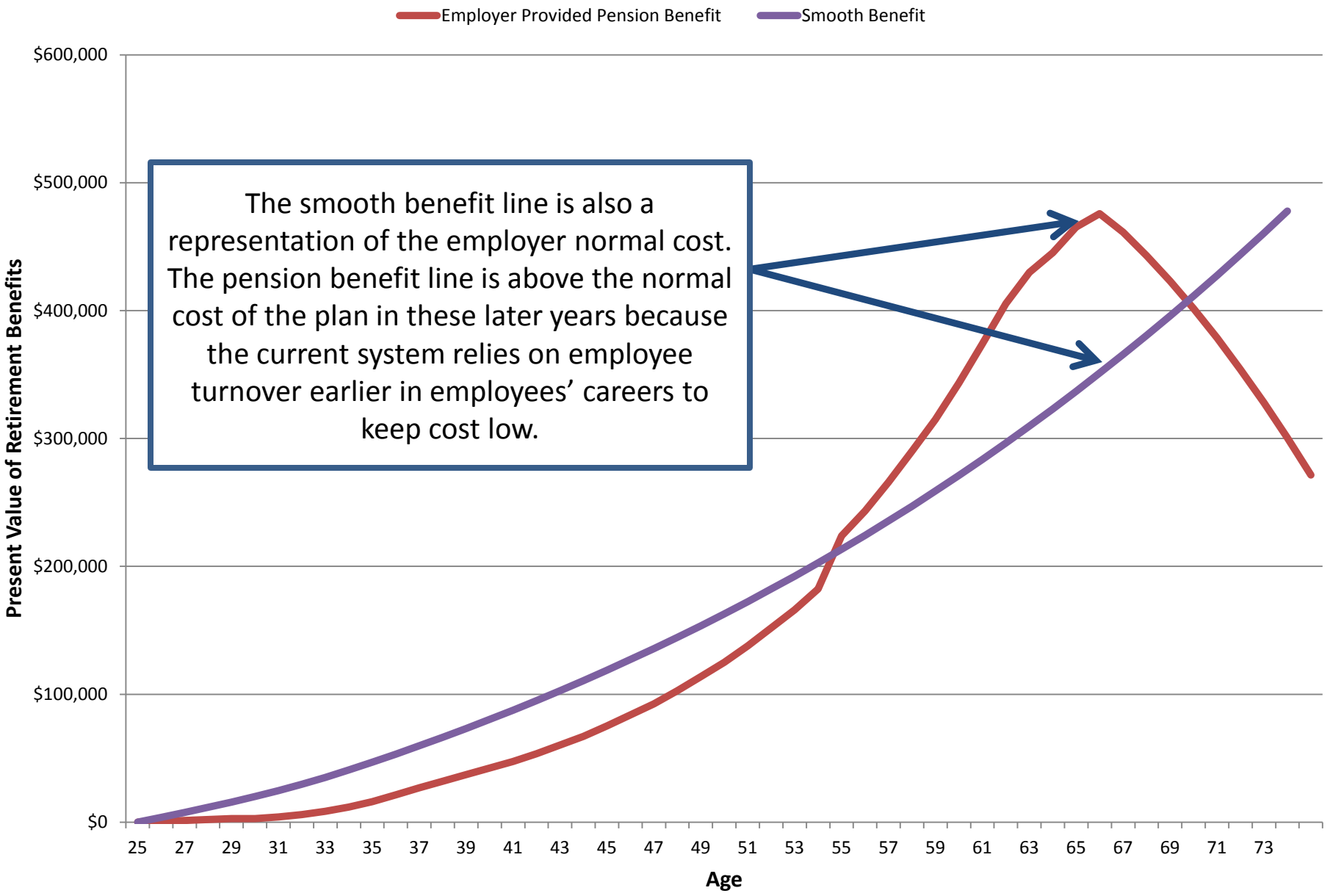

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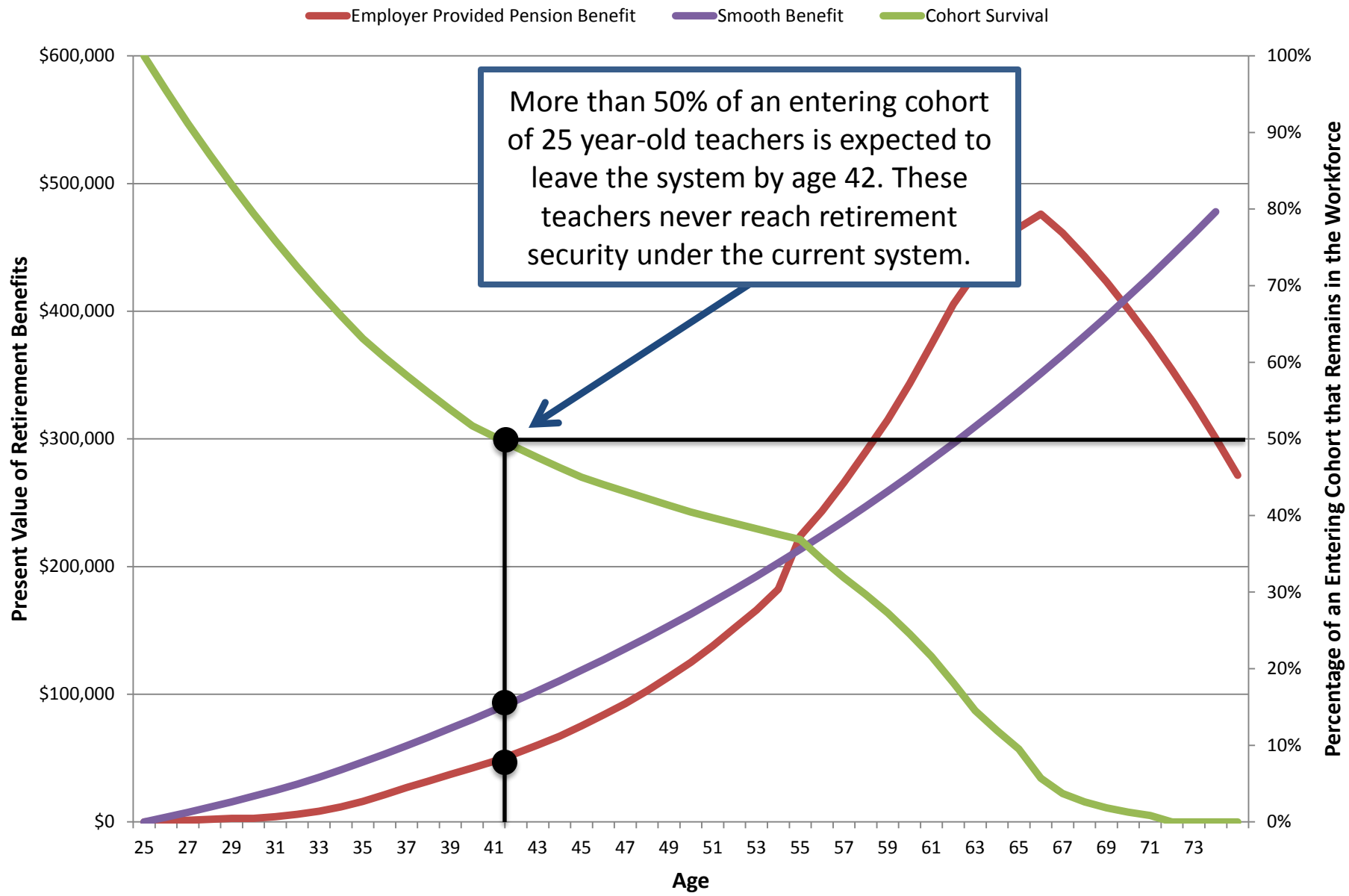


FAS DB

- Sustainability
  - Plan sponsors can be fiscally disciplined and pay for the retirement promises made to workers.
  - Plan sponsors can create a workable ex ante plan to deal with cost/benefit uncertainty.
  - Plan sponsors can adopt an effective governance model.
- However, in practice, FAS DB has significant limitations, which impair the model's long-term sustainability in practice.

FAS DB Limitations

- Overly Complex
  - Workers and employers only understand benefits at the retirement eligibility thresholds.
  - Large number of benefit parameters - few of which have a direct, intuitive link to plan cost.
  - Plan sponsors have very little understanding of plan dynamics and generally underestimate cost uncertainty.
  - Must predict many variables that are not core to the desired worker protections, adding unnecessary risk – salary growth, turnover, career mortality, etc.

FAS DB Limitations

- Incentive to Underfund
  - Because ultimate benefit payouts are far in the future and benefit cost is complex and uncertain, FAS DB provides a significant incentive to engage in funding practices that lower current cost at the expense of the future.
  - These practices include:
    - High discount rate
    - Long, backloaded amortization schedules
    - Underfunding the ARC
    - Overestimating mortality, turnover, salary growth

FAS DB Limitations

- When plan sponsors accumulate a pension debt, workers bear disproportionately in the cost of paying off that debt.
- When plan sponsors have no plan to deal with cost uncertainty, workers face ongoing, ad hoc benefit changes.

Different Models

- Why consider different models?
  - Provide benefits, including important protections for workers, more simply and transparently.
    - Remove uncertainty associated with non-core variables
    - Isolate the promises that are made to workers
    - Develop clear rules for dealing with cost/benefit uncertainty
  - Improve benefit equity and portability and ability to design benefits to target specific types of workers.
  - Reduce the incentive and opportunity to engage in funding practices that harm the system's long-term sustainability.

Different Models

- Cash Balance and Defined Contribution represent the simplest, most transparent models for providing retirement benefits.
- Both models can incorporate important protections for workers.
  - Adequate savings and benefit accrual rates
  - Professionally managed, low-fee investments
  - Annuities upon retirement
- Both models explicitly isolate the contribution rates, investment promise, and annuity promise.

Cash Balance

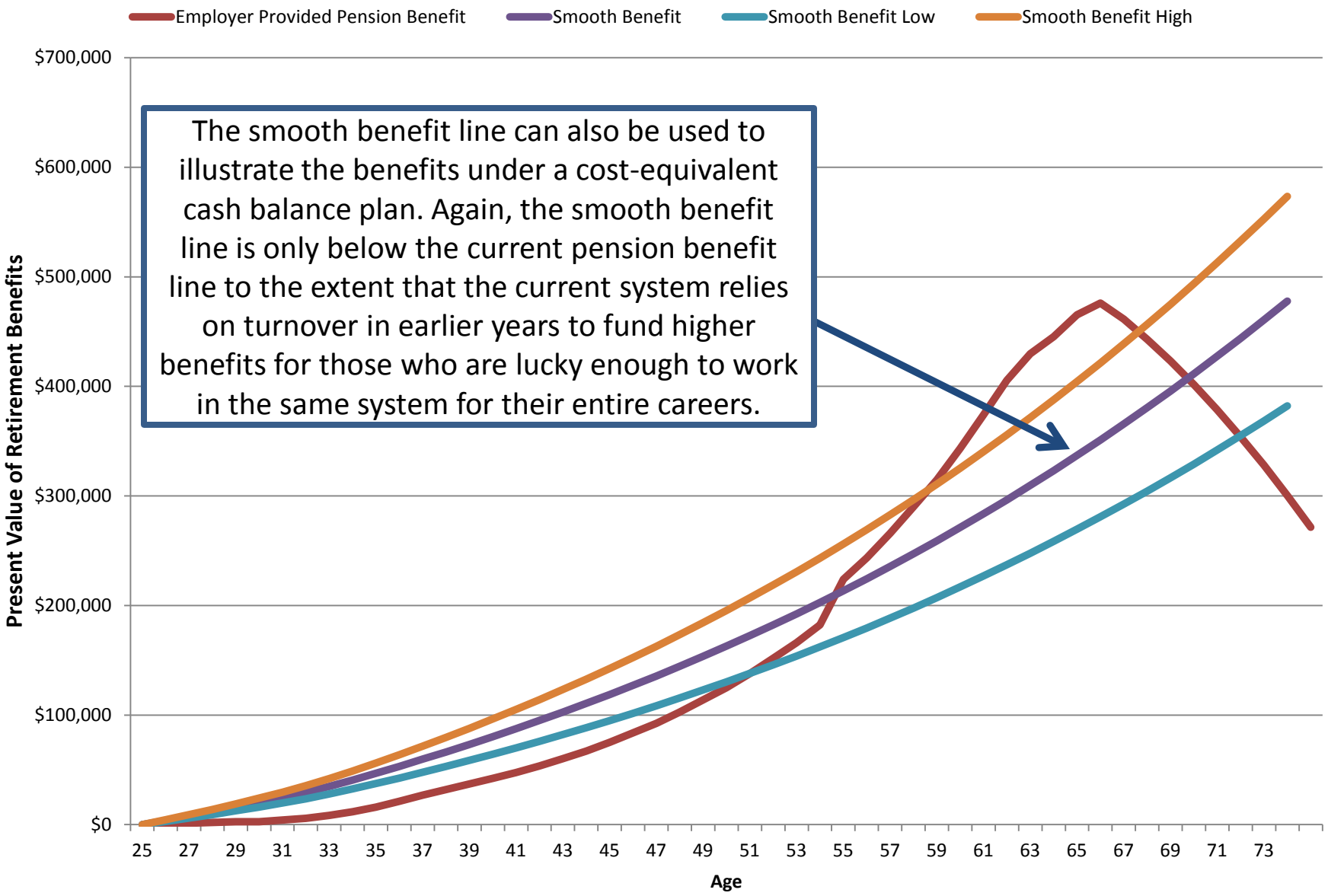
- Employee and employer make annual contribution to the plan.
- Plan manages the investments.
- Employer promises an average annual return.
- Employees' benefits are tracked by notional accounts.
- The employer must provide employees with lifetime income options (annuities) upon retirement.
- Employer may provide lump-sum options, but this is not required.

Cash Balance

- Average annual return promise can be handled in a number of ways.
  - Louisiana – 0 percent guarantee and employee accounts are credited with the plan return less 1 percent.
  - Kentucky – 4 percent guarantee and employee accounts are credited with 75 percent of the return above the guarantee calculated using 5-year smoothed plan return.
  - Kansas – 5.25 percent guarantee
  - Texas County and District Retirement System – 7 percent guarantee
- It is important that the investment promise is managed through simple, transparent rules.

Example Cash Balance

(±20% benefit cost sharing, 25-year old entrant, adjusted for inflation)



Defined Contribution

- Employee and employer make annual contribution to employee accounts.
- Employees can be provided with a limited set of investment options or a single option.
- Investments can be managed internally or externally.
- Employer may design investment products that offer a guaranteed return.
- The employer may provide employees with lifetime income options, annuities, upon retirement.
- Annuities can be provided internally.
- Employer may limit lump-sum dispersals.

Defined Contribution

- Please see the references linked below for additional information on best-practice DC plans and how the DB-DC debate is often clouded by false arguments.
  - Equivalent Cost for Equivalent Benefits: Primary DC Plans in the Public Sector – LJAF Report
  - The Dysfunctional 'DB vs. DC' Pensions Debate: Why and How to Move Beyond it - Rotman International Journal of Pension Management

Defined Contribution

- The example of West Virginia only demonstrates that a poorly implemented DC plan does not provide workers with retirement security.
  - West Virginia did a poor job of selecting investment options for the plan.
  - The majority of workers invested very conservatively.
- Poorly implemented DB also fails to provide retirement security. For example look at the benefit cuts that have occurred in 48 of 50 states – the most stark cuts have occurred in:
  - Rhode Island
  - Illinois
  - Detroit, etc.

Defined Contribution

- Many employers, including public employers, have provided workers with retirement security through a DC plan.
- For example, TIAA-CREF has provided well-designed DC plans to nonprofits and higher education for decades.
- Just like a bicycle designed with a square front wheel does not prove that bicycles are inferior to walking, a poorly designed DC plan does not prove that the model is inferior to traditional DB.
- A best practice DC plan can provide equivalent benefits at equivalent cost to a DB plan while also reducing benefit complexity and increasing transparency.

Transition Cost

- The myth of transition cost is a fiction.
- The argument that any change in the retirement system will result in large cost has been used to derail what could have been otherwise productive reform discussions.
- The myth of transition cost is based on faulty arguments and poor accounting.
- For a complete handling of the issue please see the materials linked below.
  - The Transition Cost Mirage – LJAF Report
  - "GASB Won't Let Me" – A False Objection to Public Pension Reform – LJAF Report
  - Transition cost not a bar to pension reform – in Pension & Investments Magazine

This is the End

- All primary retirement plans can incorporate important protections for workers:
  - Adequate savings and benefit accrual rates
  - Professionally managed, low-fee investments
  - Annuities upon retirement
- FAS DB has a number of design limitations, which can harm the retirement security of workers and the long-term sustainability of the system.
- Cash Balance and Defined Contribution should be considered viable primary plan models.
- Both models can be designed to protect workers while also providing a simpler, more transparent benefit.