Defined Benefit Versus Defined Contribution Plans

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Overview

- Why Offer a Retirement Plan?
- Plan Design Objectives
- Types of Retirement Plans
- Key Issues in Moving to a DC Plan
- DC/Hybrid Plan Conversions
- GFOA Best Practices

Why Offer a Retirement Plan?

- Traditional Reasons
  - Recruitment – "everyone else has one"
  - Reward career employees for long service
  - Incent employees to work harder
  - Facilitate the retirement of older less productive employees
  - Retain experienced employees
  - Provide adequate retirement income for career employees

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Why Offer a Retirement Plan?

- Contemporary Reasons
  - Attract mid-career employees to fill experience gaps
  - Attract technology savvy new recruits
  - Retain skilled workers in the workforce for a longer time
  - Manage turnover and retirement patterns of employees
  - Address employee life-cycle changes (including changes in cash spending needs, college savings needs, retirement savings needs, retiree health care needs, elder parents needs, etc.)

Plan Design Objectives

- An effective retirement plan provides:
  1. The right benefit
  2. To the right person
  3. At the right time
  4. For the right cost

Plan Design Objectives

- An effective retirement plan provides:
  1. The right benefit
     - What is the right amount of retirement income (i.e., replacement ratio) to provide to employees?
  2. To the right person
     - What categories of employees should the retirement plan target -- career employees, short service (serial career) employees or mid-career hires?

Plan Design Objectives

- An effective retirement plan provides:
  3. At the right time
     - When is the optimal time (i.e., target retirement age) to incent or induce employees to leave the workforce?
  4. For the right cost
     - What is the appropriate level of cost sharing and risk sharing between employees and the employer?

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Types of Retirement Plans

- Defined Benefit Plan
  - Traditional defined benefit pension plan
  - Cash balance plan
  - Pension equity plan
- Defined Contribution Plan
  - 401(k)
  - Money purchase plan
  - 457 plan
  - 403(b) plan

Types of Retirement Plans

- Traditional Defined Benefit Pension Plan
  - Provides each employee with a specified level of monthly retirement income which is "defined" in the plan document, and is typically based on the employee's compensation and years of service.
  - Ancillary benefits are typically provided in the event of death or disability.
  - It is also common in public sector plans to provide a cost-of-living adjustment to the monthly benefit after retirement.
  - Costs are typically shared by both employer and employees, but increases in costs are usually borne totally by the employer.

Types of Retirement Plans

- Traditional Defined Benefit Pension Plan
  - Investment, longevity and inflation risks are borne by the employer.
  - Such plans are sometimes neither appreciated, nor well-understood by younger or shorter service employees.
  - These plans are generally more complex to administer than defined contribution plans.
  - If funded consistently on an actuarially sound basis, traditional DB plans are the most efficient vehicle to provide retirement income to employees.

Types of Retirement Plans

- Cash Balance Plan
  - DB plan that mimics a DC plan.
  - It provides retirement, death and disability benefits like any other pension plan, but each employee has an "account balance”.
  - Each year a stipulated percentage of annual pay and a predetermined rate of investment income (often based on current fixed rate returns) are credited to a participant’s notional account.
  - Termination or retirement benefits are based on the account balance rather than directly on a pay or service-related formula and paid out as a lump sum.

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Types of Retirement Plans

- Cash Balance Plan
  - Periodic benefit statements showing an account balance may increase employee satisfaction with the plan.
  - Allows employers to use a defined contribution approach (an account balance), while still protecting employees from adverse investment experience.
  - **Usually** designed to provide less benefit to employees at lower cost for employer than traditional DB plan.

Types of Retirement Plans

- Pension Equity Plan
  - DB plan that mimics a DC plan.
  - It provides retirement, death and disability benefits like any other pension plan, but each employee has an "account balance”.
  - Each year a stipulated percentage is credited to the participant’s notional account.
  - The benefit at termination or retirement is typically equal to the accumulated percentages multiplied by final average pay at retirement and paid out in a lump sum.

Types of Retirement Plans

- Pension Equity Plan
  - **Usually** designed to provide less benefit to employees at lower cost for employer than traditional DB plan.
  - Large account balances may encourage terminations because in-service withdrawals are not permitted.

Types of Retirement Plans

- 401(k) Plan
  - A DC plan that allows employees to elect to defer a portion of their income into an account in their name which is tax deferred until retirement.
  - The employer may match contributions as an inducement for employees to contribute.
  - Employees usually given the opportunity to select the investment vehicles for their funds.
  - Investment, longevity and inflation risks borne by employee.
  - Actual account balance maintained for each employee and paid out, usually in a lump sum, at retirement, termination or death.

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Types of Retirement Plans

- 401(k) Plan
  - These plans are easy to understand and popular with employees who generally like the ability to decide on the investment options for their deferrals.
  - Without effective employee communications, employees may not elect to defer (i.e., save) enough or make appropriate investment choices, resulting in inadequate retirement income.
  - These plans do not typically provide ancillary benefits such as death or disability benefits.
  - These plans are always 100% funded since employee deferrals and employer contributions must be contributed to employee accounts.

Types of Retirement Plans

- Money Purchase Plan
  - A DC plan that typically provides for a stipulated percentage of pay to be allocated to the account of each employee each year.
  - The account balance is annually credited with interest based on the actual investment return and is paid out, usually in a lump sum, at retirement, termination or death, but can be converted to and paid out as an annuity.
  - Administration is relatively simple.
  - Employees generally appreciate the accumulation of money as shown on their statements.

Types of Retirement Plans

- Money Purchase Plan
  - There is no guaranteed monthly income at retirement.
  - Investment, longevity and inflation risks borne by employee.

Types of Retirement Plans

- 457 and 403(b) plans
  - Similar to a 401(k) plan – i.e., a DC plan that allows employees to elect to defer a portion of their income to the plan which is tax deferred until retirement.
  - 457 plans are available for governmental employers.
  - 403(b) plans are available for public education organizations.
  - There is no guaranteed monthly income at retirement.
  - Investment, longevity and inflation risks borne by employee.

Key Issues in Moving to a DC Plan

- The recent financial crisis and recession has resulted in increased and more volatile contribution requirements by DB plans.
- In response, some governments are considering moving to DC or hybrid plans primarily as a way to control/reduce costs and make budgeting for benefits an easier and more predictable process.
- However, before this is done, it is important to fully understand the implications of such a change.

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Key Issues in Moving to a DC Plan

- Moving from a DB to a DC plan is not likely to immediately reduce total benefit costs.
  - Conversions to DC plans may only be applicable to new employees due to the benefit protections afforded to employees by collective bargaining agreements, constitutional guarantees, laws, court cases, etc.
  - Governments will need to phase in lower cost DC plans gradually as new workers enter the system; therefore, it may be decades before a plan conversion yields substantial cost savings for state and local governments.

Key Issues in Moving to a DC Plan

- Moving from a DB to a DC plan may actually increase plan costs in the near term.
  - Benefits accrued to members in the closed DB plan must still be funded and paid; they don't just disappear.
  - Jurisdictions with large underfunded pension liabilities may find the cost of paying off DB plan costs while creating new defined contribution plans for new workers too expensive.
  - Jurisdictions with reasonably funded retirement plans may be able to tolerate higher short-term costs in exchange for minimizing future costs.

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Key Issues in Moving to a DC Plan

- The typical funding policy for public sector DB plans is for employees and the employer to jointly fund the cost of benefits on a systematic basis over time.
- When new workers go into a DC plan, their contributions go only to the DC plan. So the portion of their contributions that would pay for the current deficit under the DB plan will not be contributed into the plan. This means that contributions from the governmental entity and it's current employees may likely need to be increased.
- This is illustrated in the following charts.

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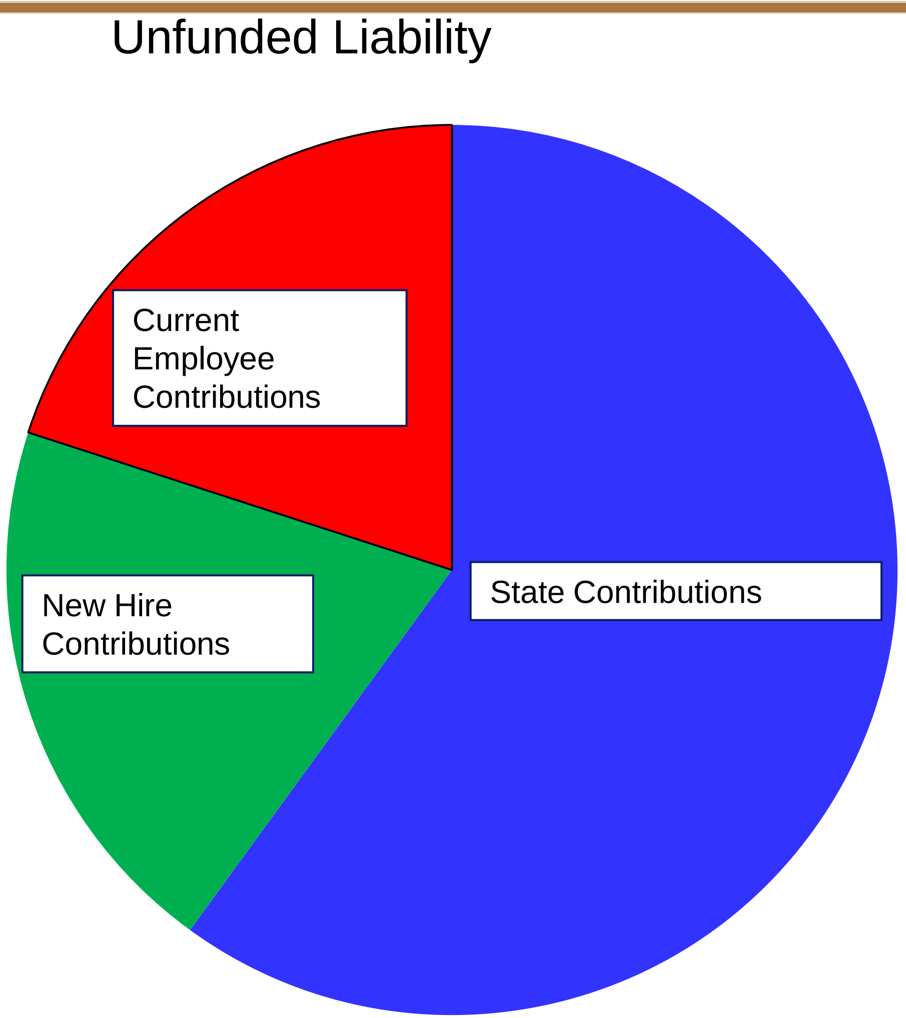
New Hires Pay Some of the Deficit



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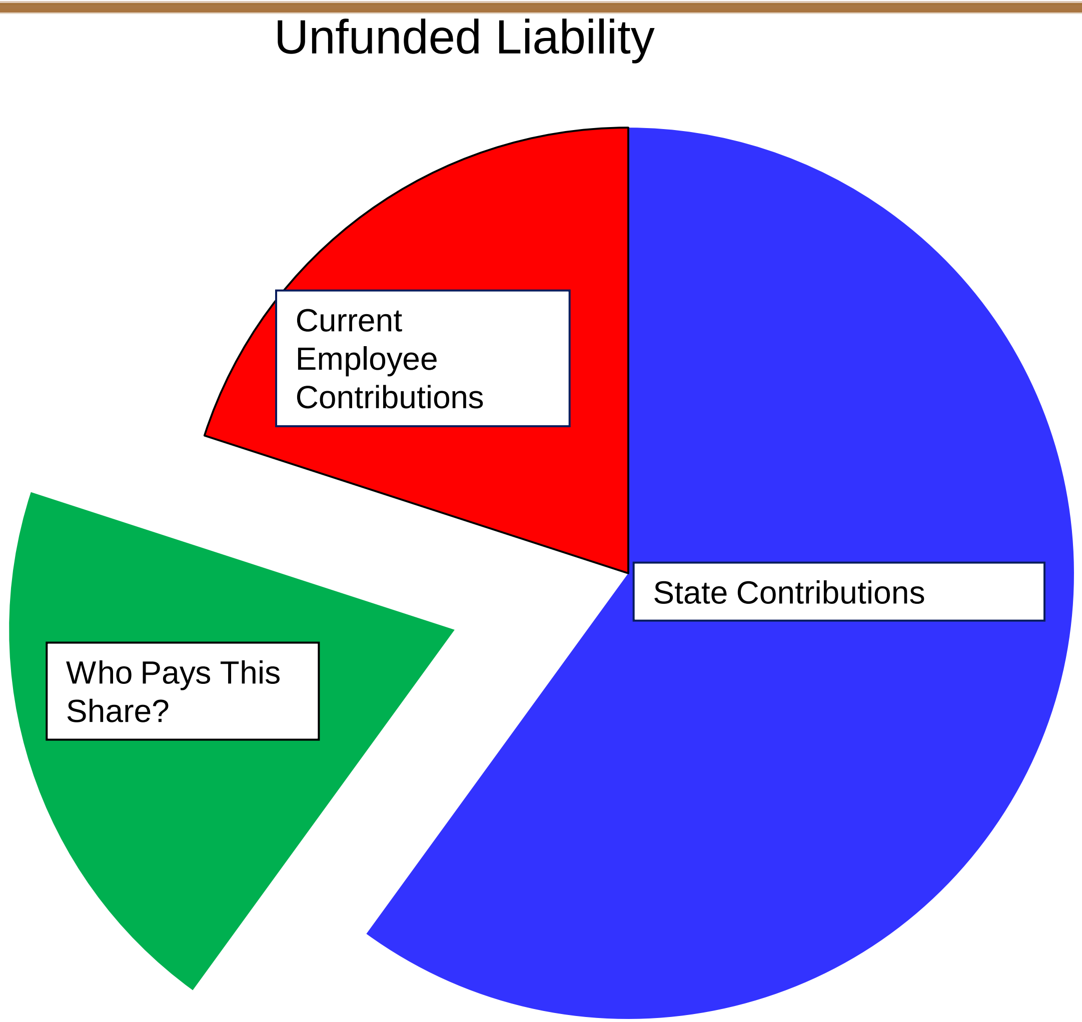
Without New Hires, Who Covers Their Contributions?



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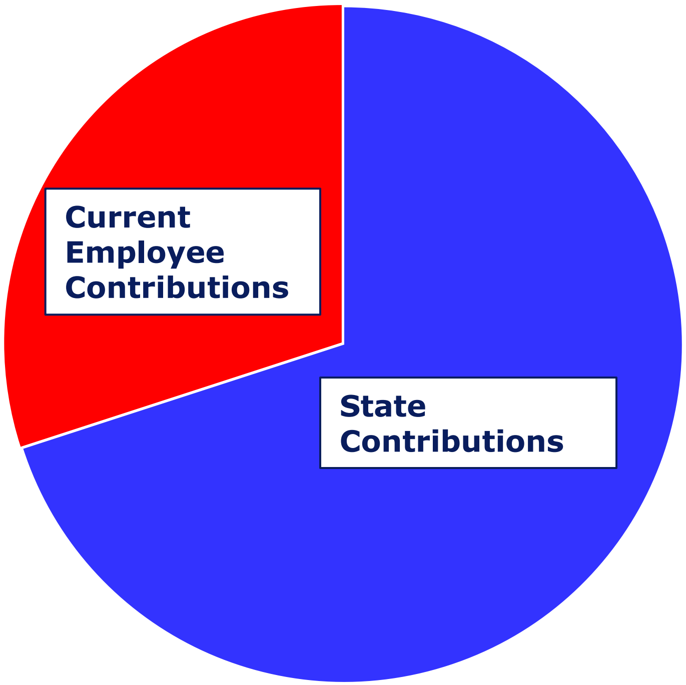
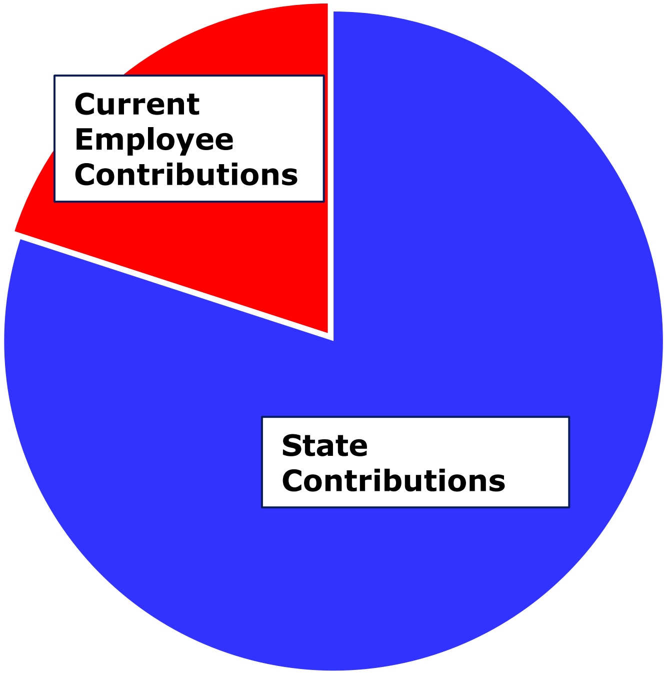
Without New Hires, Who Covers Their Contributions?

State and Current Employees Share Additional Costs on a 50%/50% Basis



State Picks up all Additional Costs



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Key Issues in Moving to a DC Plan

- Moving from a DB to a DC plan may affect the jurisdiction's ability to attract and retain qualified employees
  - This will depend on the labor market, but attracting qualified employees may be difficult if other jurisdictions provide DB plans.
  - DC plans may attract younger employees, but may not be effective for retention.

Key Issues in Moving to a DC Plan

- Moving from a DB to a DC plan means transferring investment, longevity, and inflation risk to employees
  - This may jeopardize retirement security if employees don't know how to manage these risks.
  - If employees are not covered by Social Security, moving to a DC plan may create even more risk.
  - As a result, they may have less to contribute to the local economy.
  - Some may require public assistance, which would not be offset by investment income.

DC/Hybrid Plan Conversions

- Since the mid-1990s, legislation has been proposed to replace state and local government DB plans with DC plans.
- The pace increased in 2003-2006, partly as a result of the equity market downturn in 2000-2002. It fell in 2007-2008, but picked up again in 2008-2009 as a result of the financial crisis.
- By 2009, 10 states had introduced some form of DC plan, either alone or in conjunction with hybrid plans.

DC/Hybrid Plan Conversions

- Since 2009, three states have taken action (GA, MI, UT) – but the new plans are "hybrid" or combination DB/Dc plans rather than pure DC plans.
- Currently 8 states are considering implementing DC plans (AL, CT, IL, NC, NV, OK, TN, WI).

DC/Hybrid Conversions - Examples

State	Plan	Year	Covered Employees	Type	Mandatory/ Optional	EE Contribution	ER Contribution (% Earnings)	Years to Vest in ER Portion
MI	SERS	1996	General	401(k)	Mandatory New Hires	Up to 401(k) Limit	4% + 3% Match	4 years
WA	SERS Plan 3	2000	School	DB/ DC	Mandatory New Hires	5% - 15%	ER Funds 1% DB Multiplier	5 years
FL	Optional Plan	2000	General, Teachers, Public Safety	DC	Optional	None	9% General 20% Public Safety	1 year
OH	STRS	2003	Teachers	DC	Optional	10.0%	10.5%	5 years
OH	STRS	2003	Teachers	DB/ DC	Optional	10.0%	ER Funds 1% DB Multiplier	5 years
AK	Alaska DC Plan	2006	General, Teachers, Public Safety	DC	Mandatory New Hires	8% Minimum	5% General 7% Teachers	5 years

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DC/Hybrid Plan Conversion -- Atlanta

- Current Employees
  - Contribute extra 5%
  - No other benefit changes
- New Hires
  - Placed into a reduced traditional pension with a 1% multiplier and an 8% employee contribution .
  - The retirement age for newly hired general city employees is increased to 62 from 60 and to 57 from 55 for police officers and firefighters.
  - Also receive a 401K-type plan with a 3.75% mandatory contribution that is matched 100% by the city. These employees may also contribute an additional 4.25% that will be matched by the city.

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DC/Hybrid Plan Conversion -- Utah

- Current Employees
  - No Changes
- New Hires
  - Choice between a
    - 401(k) plan with a 10% employer contribution (12% for public safety workers and firefighters), or a
    - Hybrid DB/DC plan (with a combined maximum 10% employer contribution)
    - Under the hybrid DB/DC plan, if the pension contribution rate exceeds 10%, the employee must make up the shortfall
    - Under the hybrid DB/DC plan, the DB benefit is 1.5% of FAS times years of service and includes up to a 2.5% COLA on the original retirement benefit

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GFOA Best Practices

- The GFOA has several related Best Practices on its website, including:
  - Developing a Policy for Retirement Plan Design Options (1999, 2007)
  - Essential Design Elements of Defined Contribution Plans as the Primary Retirement Plan (2008)
  - Participant Education – Guidelines for Defined Contribution Plans (2009)
  - Essential Design Elements of Hybrid Retirement Plans (2008)

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Questions?

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