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Pennsylvania Pension Reform: A Way Forward

While the existing unfunded liabilities have to be addressed in order to put the state on sound financial footing, a pension plan for future state employees that provides benefit adequacy but avoids the likelihood of new unfunded liabilities must be implemented. A reasonable path to consider is to utilize defined contribution as a primary retirement plan component or in a defined benefit/defined contribution hybrid design.

CORE DC PLAN MODEL

A core or primary DC plan could be open only to new employees, or to both new employees and select existing participants. Some governments have reservations about migrating from the traditional DB structure to a core DC format. Plan sponsors cite a variety of risks that can cause standard DC designs (e.g. 401(k) or 457(b)) to fail, including inadequate savings and confusing investment choices. However, plan sponsors can establish plan features that will help ensure adequacy of contributions and investment structures that support appropriate investment decision-making. Plan objectives should include:

Provide Employees with the Means to Build Sufficient Savings. While participation is key, so are contribution rates. Under-saving remains one of the biggest factors affecting retirement preparedness. Plan sponsors can help by setting:

- Shorter vesting schedules.
- Total contributions by employer and employee that represent at least 12% of employee pay if the participant will receive Social Security and at least 18% if the participant will not be receiving Social Security benefits. Higher contribution rates for public safety employees are needed to address earlier retirement ages.

Ensure Participation in the DC Plan. A common misconception about DC plans is that they lower participation. Plan sponsors can establish plan features that encourage participation and overcome employee inertia, by establishing:

- Mandatory enrollment through an automatic enrollment mechanism.
- Lower, or no, age restrictions on participation.

DB/DC Hybrid Design

A properly designed hybrid plan couples a degree of guaranteed benefits through a smaller traditional defined benefit plan with a risk-managed defined contribution plan that is focused on income adequacy in retirement as its primary goal. The defined contribution portion of this hybrid design properly focuses on retirement income and risk management rather than on asset accumulation, thus distancing itself from a typical 401(k) or 457(b) plan. The reduced DB benefit can help governments lower new DB funding obligations for future years of service while still providing a guaranteed benefit protecting participants from investment and longevity risk. The addition of the DC plan is designed to fulfill the remaining retirement needs of employees without adding any pension funding risk to the Commonwealth of Pennsylvania or its taxpayers. Defined contribution critics tend to compare aspects of defined benefit plans with 401(k) or 457(b) supplemental savings structures, not with a properly designed, risk-managed defined contribution pension structure. In fact, defined contribution core retirement plans have been providing superior lifetime retirement income to government employees for almost a century. In these plans risks are minimized and shared through several design features while costs are kept low and employee career mobility is addressed in a way that is not possible in traditional defined benefit plans.

The plan should be designed to provide income adequacy in retirement for employees. Most experts agree that an income replacement ratio of somewhere around 75% is appropriate for most employees. With this as a background, let's look at specific design features.

Contribution rates for the defined contribution portion of a hybrid would depend on whether the particular employee group participates in Social Security or not.

DC PLAN CONTRIBUTION RATE REQUIRED TO ACHIEVE A 75% INCOME REPLACEMENT RATIO

Entry Salary	DB Formula	Social Security Replacement Ratio	DC Rate With Social Security	DC Rate Without Social Security
$40,000	**1.0%**	**31.7%**	**2.5%**	**12.1%**
$60,000	**1.0%**	**26.6%**	**4.1%**	**12.1%**
$80,000	**1.0%**	**22.6%**	**5.3%**	**12.1%**

Assumptions:
Entry Age is 30, Retirement Age is 65; Salary Increase is 4%; DB benefit replacement ratio is equal to formula times 35 years of service; Interest Rate is 6%; DC accumulation is used to purchase a Single Life Annuity w/10 years guaranteed; Annuity purchase rate based on 4% interest and current TIAA mortality; Social Security benefits based on current benefit formula, and 3% inflation
The above scenarios are based on hypothetical assumptions and are not intended to represent the performance of any specific investment product. They cannot be used to predict or project investment company performance.

As noted above, the hybrid plan for new Pennsylvania employees is not intended to replace the traditional DB plan. Rather it incorporates the DB plan, at a lower benefit formula, into the hybrid design. A 1% DB multiplier will likely require a total contribution rate of between 5% and 6% of payroll with normal assumptions. Given that, the total cost of the DB/DC hybrid would range between 8.5% and 18.5% of payroll depending on Social Security participation. This total cost can be split between employer and employee in any way that meets the workplace objectives of the Commonwealth.

<u>Risk-Managed Construction</u>

Several design considerations to the core defined contribution design or to the defined contribution portion of the hybrid plan should be incorporated to help maximize the likelihood of retirement income adequacy while minimizing risks.

- **Investment Design** – Since employees need to properly diversify their investments and rebalance their portfolios regularly to maintain a prudent asset mix, these aspects need to be incorporated in plan features. With the proper plan architecture plan sponsors can support wise participant decision making by offering:

  - A limited lower cost investment menu that would include 15-20 preselected options representing best in class funds in the various asset classes. These options can and should include fixed and variable annuities.
  - Automatic asset allocation vehicles such as lifecycle or target-date funds that provide an age appropriate asset allocation.
  - Individual investment advice to help educate participants and enhance their decision-making prowess.
- **Accumulation Distribution at Retirement**
  - A mechanism to automatically convert a sufficient portion of a participant's accumulated assets to a low-cost annuity, or other lifetime income vehicle, upon retirement in order to guarantee lifetime income.
  - Restrictions to prevent employees from taking large early distributions from their plan, thus preventing leakage from their accounts and helping them retain sufficient assets for retirement.
- **Communication, Education and Advice** - A comprehensive program to help plan participants understand the options that they have and make sound decisions must be part of the overall plan.
  - Included in this program should be the availability of communications, education and advice through multiple channels including face-to-face, web-based and telephone.
  - Specific investment advice, with fiduciary responsibility, should be available to employees through all channels and without additional cost to the participant.
  - Counseling on retirement income preparedness and options is also a key part of the communications plan.

Consider also that career mobility is now the norm in essentially all employment categories. According to the US DOL, Bureau of Labor Statistics,[i] median years of tenure with current employer in the private sector in 2010 was 4.0 years. In the state government sector the same median tenure figure was 6.4 years. While tenure with state government employers remains longer than in the private sector, these statistics clearly illustrate the need for portability of retirement benefits for government employees.

In November 2011, Rhode Island, faced with one of the highest levels of unfunded pension liabilities on a per capita basis in the U.S. (along with Illinois), passed sweeping legislation that addressed their public pension crisis. State employees and teachers participating in a traditional defined benefit plan were moved, for future service, to a new hybrid model comprised of the traditional plan with reduced benefit levels and costs paired with an individual risk-managed defined contribution account. The hybrid model also applies to new members of Rhode Island's public retirement system.

Several municipalities, including the $56 billion Virginia Retirement Systems and the $22 billion Utah Retirement Systems have moved toward hybrid defined benefit/defined contribution models, while others are considering legislation that goes in that direction.

The $9.4 billion Orange County Employees Retirement System recently gave new employees a choice to join the defined benefit plan or a newly created defined benefit/defined contribution hybrid, while the Atlanta City Council approved a hybrid plan for all new employees last year.

While the traditional defined benefit pension plan remains prominent in the public sector, it is being scrutinized and reconsidered. Traditional 401(k) or 457(b)-style defined contribution plans have also proven to be too risky to serve as a primary retirement savings vehicle. The core DC or hybrid plan design features outlined here offer plan stakeholders in the Commonwealth of Pennsylvania a way forward that can address the lifetime income security needs of employees while being sensitive to the funding concerns facing governments. As stewards of public employees' retirement security, Pennsylvania leaders need to act with reason, fairness and a measure of expediency.

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[i] United States Department of Labor, Bureau of Labor Statistics, Economic News Release, **Employee Tenure Summary, September 14, 2010**