State Retirement Reform Legislation

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(1) Intro Slide

- Chairman Brubaker, members of the committee, thank you for inviting NCSL to testify here today.
- I'm here today to review the kinds of retirement system legislation that states have been enacting in the past few years.

(2) Overview

- There are several thousand government-sponsored retirement systems in the U.S., and I understand that there are over 100 here in Pennsylvania.
- While there are a huge number of individual systems, the data I'm presenting today relates to the main state-administered systems.
- These account only 6% of the systems, but they represent 88% of the active system members and 83% of the assets. So, I'm focusing on the "6%" today.
- When comparing systems, it's important to keep in mind that 30% of state and local governmental employees are not covered by Social Security, so in those systems the benefits and employer contributions are on average higher to make up the lack of Social Security.

(3) Overview Cont'd

- We are tracking retirement system legislation in every state this year.
- As of last week, 144 pieces of retirement system legislation have been enacted in 2013.
- I have included some information about 2013 enactments so far, but please note that we are still analyzing these 144 bills, and more are sure to be enacted, so it will take us a little time to have a complete picture of the total retirement system changes enacted this year.

(4) Overview Cont'd

- As you are aware, the Great Recession caused tremendous changes to state budgets and the funding levels of state pension plans.
- So, I've arranged my presentation to look overall at the types of reforms that states have taken starting in 2009.
- Unsurprisingly, the years since the start of the Great Recession have been a very busy period for state legislation dealing with pensions.
- In 2011 we saw 32 states enact significant changes, 10 states enacted significant changes to their pension plans in 2012, and we've seen 5 states plus Puerto Rico do so this year.

(5) Major Pensions Legislation in 2009-2012: All Topics

- Here's a map of the states that have made significant changes in recent years.
- Alaska made significant changes in 2005 & 2006, so really Idaho now stands alone.

(6) Significant Structural Changes in 2012

- Last year we saw 10 states make significant changes.
- In Louisiana, the enactment of their new cash balance plan was ruled unconstitutional on January 24, 2013 by the 19th Judicial District Court on the grounds that the House of Representatives passed the legislation with a simple majority rather than a two-thirds majority required by the Louisiana Constitution for certain legislation.
    - The legislature has delayed the implementation of the cash balance plan until 2014 while awaiting the results the court appeals process.

(7) Significant Structural Changes in 2013

- So far this year 5 states plus Puerto Rico have made significant structural changes.
- Kentucky created a new cash balance plan for future hires beginning on July 1 of this year.
- Puerto Rico, whose pension system was teetering on insolvency, converted its DB plan into a hybrid plan.

- I'll mention the other significant changes on the states noted here in subsequent slides.

(8) Increases in Employee Contributions 2009-2012

- Much of the legislation in the past few years has been concerned with increases in employee contributions - that's what this map shows you.
- In a surprising number of states the increased contribution requirements have affected current employees - something that has historically not been the case prior to the Great Recession. Increasing contribution requirements for current employees was previously a very, very rare enactment.
- Not surprisingly, some of these changes have been challenged in courts.
- Please note that in Michigan, the mandatory 4 percent employee contribution to the pension system for all state employees who chose to remain in the Defined Benefit (DB) their 2011 reform legislation was ruled unconstitutional by a county circuit court. While this issue continues to be litigated, the 4 percent contribution continues to be deducted until this issue is resolved. Because the employee contributions continue to be deducted, I've left it as green for now.

(9) Increases in Employee Contributions 2013

- Looking at this year we've seen at least 3 states so far require increased employee contributions.
- Montana's employee contribution rate was previously set to decrease by 1%, and that was repealed keeping the rate at 7.9%. A separate bill there will increase teacher contribution rates, for current employees and new hires, by 1% a year, for 4 years.
- New Mexico increased contribution rates, also for both current employees and new hires.
- Nebraska also eliminated a scheduled sunset of a lower rate and also increased the rate for a certain tier of its school employees system.
- If the trend from previous years continues, there are sure to be a few more states represented on this map before the year is over.

- Lets look at a typical case of a state requiring increased employee contributions…

(10) Changes in Employee Contributions in 2012 - Kansas

- In Kansas, existing members of their oldest plan, which was closed to new members in 2009, were given a choice between increased contributions and reduced benefits.
- For members of the most recent plan, the contribution amount was not increased, but instead their benefits will be eventually reduced.

(11) Changes in Employee Contributions in 2012

- New York adopted in 2012 an unusual system of scaling employee contributions, only for new employees, to the amount of money that they make.
- Overall this will result in increased contributions collected by the system. For the lowest-paid employees this will not change the contribution amount. For higher-paid employees it will increase the contribution amount substantially, especially at the higher salary levels.
- New York also capped the amount of salary on which contributions will be made and capped the amount of salary on which benefits will be calculated in the future. The cap is set at the governor's salary, currently $179,000, the cap will float upward if the governor's salary is increased in the future.

(12) Higher Age and Service Requirements for Normal Retirement, for New Members, 2009-2012

- Another kind of widespread pension reform in recent years has been enacting higher age and service requirements for normal retirement.
- By normal retirement, I mean the age and service at which a person is entitled to the benefits that the standard formula provides, without the kind of reduced benefits that's called an early retirement benefit.
- 32 states had done that from 2009 through 2012.
- Some of the states moved the retirement age from 60 to 62, some moved it from 62 to 65, and in the case of MO & IL increasing it to 67. In MO & IL the

retirement age of 67 is only applicable for employees hired as of the beginning of 2011.

(13) Higher Age and Service Requirements for Normal Retirement, for New Members, 2013

- This year we have seen similar changes so far.
- Nebraska, New Mexico and Montana all created a new tier in one or more of their systesm.
- Montana created a new tier of benefits for members of their Teachers System hired after July 1, which reduces the employer’s normal cost rate, requires members to work longer before they are eligible for benefits, and reduces benefits for most new hires.
- Nebraska modified the defined benefit plans of for School Employees. (Note that state employees are in a cash balance plan).
- This legislation created a new tier with reduced benefits school employees hired after July 1; their final salary will be averaged over 5 years instead of 3 years; and eligibility for membership is changed from 15 hours a week to 20.
- The new tier in the New Mexico public employees plan requires increased age and service requirements, a longer Final Average Salary calculation and also increases vesting periods.
- New Mexico also created a Tier 3 plan for teachers with additional eligibility requirements for new members hired after July 1, 2013.

(14) Higher Age and Service Requirements for Normal Retirement, for New Members, 2012- ALABAMA

- Let’s look for a moment at Alabama’s changes last year…
- What I've shown you here first is Tier 1, which was the retirement plan before it was changed, which allowed for retirement after 25 years of service or at age 60.
- Starting on January 1 of this year all newly hired employees fall into the newly-created tier 2.
- This tier raises the retirement age to 62 and the old provision that allowed for retirement whenever someone had reached 25 years of service - that's been repealed for new members.

- Also, Alabama increased the length of the base on which pension benefits are figured, the longer that the base period is, other things being equal, the lower the benefit would be.
- In this case, other things are not going to be equal because the percentage of base that each employee receives for each year of credited service is shrinking as well. It's shrinking quite significantly in this case, close to 4/10 of a percentage point.

(15) Higher Age and Service Requirements for Normal Retirement, for New Members, 2012- WYOMING

- For another example of recently enacted higher age and service requirements, lets look at what Wyoming did last year.
- Last year the retirement age was also raised from 60 to 65 for new employees.
- They also changed the benefits base, like Alabama, and also reduced the multipliers somewhat.

(16) Reductions in Post-Retirement Benefit Increases Enacted in 2009-2012

- Another very significant change in recent years has been in post-retirement benefit increases, or cost-of-living adjustments after people retire.
- It is standard in public sector retirement plans to provide automatic cost-of-living adjustments to help preserve retired people's ability to cope with inflation.
- These are very expensive benefits. A substantial number of states have postponed them and in some cases cancelled them and in some cases pinned them to funding levels in their retirement plans.
- As this map shows you, over the last three years, a number of states, the green states - made changes for future hires only and an equal number of states made changes for active employees and a number of states made them for people who have already retired as well as for people who will retire in the future.
- In a number of states these changes have been challenged in the courts. In the states of CO, SD, MN, and NJ the legislation has been upheld by the courts, though these will be subject to appeal in some cases.

(17) Reductions in Post-Retirement Benefit Increases Enacted in 2013

- 4 states have reduced COLAs so far this year, with the COLAs in 3 of those states being reduced for active employees AND current retirees.

(18) Reductions in Post-Retirement Benefit Increases Enacted in 2012

- Here are some examples of reductions in post-retirement benefit increases that were enacted last year.
- In 2012, Virginia capped the post-retirement increases it will give in the future.
- Wyoming instructed its board of trustees that the legislature expected them not to provide COLAs in the future until the retirement plan is fully funded. That probably amounts to a cancellation of future COLAs for some years in Wyoming, unless the law is changed.
- Looking back to 2011, Oklahoma, which has only ad hoc COLAs, enacted legislation that requires prefunding for any COLAs approved in the future.

(19) Non-DB Statewide Retirement Plans

- This map shows the states with non-defined benefit statewide retirement systems.
- There are 13 states where new employees (as of July 1) cannot go into a pure defined benefit plan. Those are the red, blue, and green states on this map – plus Utah.
- Utah is yellow because like 6 other states employees get the choice of their primary plan – but in Utah the choice is between a hybrid plan or a direct contribution plan.
- Washington state employees have a choice between a DB or a hybrid plan.
- The rest of the yellow states offer employees a choice between a DB or a DC plan.

(20) Replaced DB Plans 2010-2012

- A number of states in recent years have made fundamental changes in retirement plan design.

- By fundamental changes, I mean a shift from Defined Benefit (DB) plans - the traditional form of plan, to Defined Contribution, Cash-Balance, or Hybrid plan designs.
- This map shows the eight states that have made this type of change from 2009 through today.
- If you're wondering what the 8th state is, it's Rhode Island; it's just a little hard to see on this slide.

<u>(21) Some States Have Replaced DB Plans</u>

- Michigan adopted a hybrid plan for school employees in 2010. Last year, Michigan added the option for school employees to choose a defined contribution (DC) plan OR the hybrid plan created in 2010.
- In 2011 Rhode Island passed legislation that transferred most members in its system to a hybrid plan.
- In 2012, three states made similarly fundamental changes to their retirement plan design.

<u>(22) Defined Contribution (DC) Plans</u>

- DC plans function like 401(k) accounts.
- DC plans can stabilize states’ costs for new hires as a fixed percentage of salary with the potential for slight variations based on how the employer matching contributions are structured.
- They allow for easier mobility in and out of state service – less incentive to stay on than with DB plans, and no penalty for employees who want to move on with only a few years of service.
- One main point is that the risks and responsibilities are shifted to the employee.
    - With these risks and responsibilities there can be a need for increased employee education about the plan.
    - Employees generally have to make more decisions than with DB plans – specifically investment decisions, and sometimes their level of the employee contribution.

(23) Virginia Hybrid Plan (2012)

- One of the three major structural changes enacted last year was Virginia's adoption of a hybrid plan. In some ways it is quite similar to the Utah hybrid plan.
- This began to apply to all new employees in Virginia state and local government, except some public safety members and judges, on January 1 of this year.
- The plan will have a defined benefit account, that's not as rich as the traditional one.
- They will also have a defined contribution account, to which they must make contributions, with a range of options as to how much they contribute to that.

(24) Rhode Island Hybrid Plan (2011)

- Rhode Island is unique because they closed their DB plan and moved current AND new employees to a new hybrid plan design.
- Rhode Island had already implemented a series of reforms to its DB plan, but found those savings still weren't enough.
    - They had changed the retirement age and modified the COLA – including for current retirees.

(25) Rhode Island Hybrid Plan Cont'd (2011)

- This slide provides some of the provisions of the new hybrid plan.
- There are higher employer and employee contributions for those without social security coverage. But, they are still all in the same system.
- The new plan is in effect, though it remains in litigation. A judge sent the cases to mediation and things are still pending there – we should hear an update soon.

(26) Michigan DC Plan (1996)

- Turning to straight DC plans, let's look at the oldest state DC plan still in use.
- MI is one of only two states, the other being AK, that require their employees to participate solely in a DC plan.
- Note that the employee contribution is optional, with a choice on whether it is on a pre-tax or a post-tax basis.

- Additionally, uniquely, the employer offers an additional matching contribution up to 3% when the employee does contribute.
    - Potentially, the employee can have up to 19% of their salary going toward their DC plan.

<u>(27) Alaska DC Plan (2005)</u>

- In 2005 Alaska joined Michigan as the other state with a mandatory DC plan.
- At that time, nonvested of their DB plans were permitted to transfer to the new DC plan.
- Unlike Michigan, the employee and employer contribution rates are fixed percentages.

<u>(28) Utah DC Plan (2010)</u>

- Remember that Utah offers its employees a choice of a hybrid or a DC plan – but there is no pure DB option in Utah.
- Like Michigan, the employee's contribution is optional, but unlike Michigan, there is no additional employer match.

<u>(29) Cash Balance Plans</u>

- Of the three states that adopted new plan designs last year, two of them, Louisiana and Kansas, have adopted what's called a cash balance plan.
- Kentucky just adopted a cash balance plan this year.
- This type of plan is very rare in the public sector.
- In some ways they are like a defined contribution plan. A cash balance plan gives every member an individual account. The employee and the employer each contribute to the account. And here's where it diverges from a 401(k) plan in the private sector or a defined contribution plan in the public sector:
- Members don't have any choices as to how the money is invested.
- The members accounts are managed in one trust account, just as they are in a traditional DB plan, and the point of that is to achieve the economies of scale and the economies of management that come with a merged trust fund.
- In public sector cash balance plans, members are guaranteed a return on their investment. This return takes different forms, but there is a guaranteed return,

and then if the trust funds' earnings make it feasible member accounts can receive additional returns over and above the guaranteed amount.

- In public plans, when the member retires, the member has, at least the option, of a lifetime annuity based on the account balance and the plan may or may not provide for some sort of cash withdrawal at that time.
- So, that's a cash balance plan…

(30) Kansas Cash Balance Plan (2012)

- Kansas adopted this after looking at alternatives for about two years.
- The Kansas DB plans will be closed to new members as of the end of 2014 and at that time new employees will go into the cash balance plan.
- Employees will contribute 6% and employers will contribute in a range of amounts depending on how long the employee has been in service under the plan.
- Kansas is providing a flat, guaranteed return of five and a quarter percent earnings with the possibility of additional earnings.
- The Kansas plan makes it somewhat disadvantageous for employees to leave service early, they don't get a particularly rich benefit out of it until they have been in the plan a long time
- And that way it is similar to traditional defined benefit plans, which are most advantageous for long term employees.

(31) Louisiana Cash Balance Plan (2012) (1)

- Louisiana also adopted a cash benefit plan last year for state employees and for higher education employees, yet their plan is quite different from that in Kansas, despite a fundamentally similar structure.
- Louisiana has higher employee contribution amounts because public employees in Louisiana are outside the Social Security system.
- The interest credit in Louisiana is not a flat amount like it is in Kansas. It's going to be 1% below the actuarial rate of return on the Louisiana trust fund earnings. It will not fall below zero, though presumably in a very bad year for investments it could fall to zero.
- The plan also provides for additional interest credits if experience allows.

(32) Louisiana Cash Balance Plan (2012) (2)

- One of the unusual features of the Louisiana cash balance plan is that after members are vested, in this case they have been members for 5 years; the employees can withdrawal the full account balance if they choose to. This would be the employee contribution, the employer contribution, and the earnings on it. They can roll it over, they can take it as cash, or they can leave it in the system and annuitize it at age 60.
- Louisiana's plan has in its details, unusually favorable provisions for members who wish to leave state service early.
- This was by design, as lawmakers were considering proposals they sought to address the issue of how to not lock people into membership in the state retirement system, and as state employees - they wanted to encourage some movement between the public and private sectors.
- As I mentioned earlier, the Louisiana cash balance plan was ruled unconstitutional on procedural grounds in late January of this year.
- Legislation passed this year will delay the implementation of the plan until 2014, with the intent of getting the court cases resolved before then.

(33) Sources and Contact

- NCSL's work is based on what the states have enacted. We track that in annual reports, our final 2012 report is available on our website now.
- As I mentioned, we're still analyzing the 2013 enactments, so please treat the 2013 counts as "at least" numbers.
- Chairman Brubaker, members of the committee, thank you very much for inviting me to testify here today.
- I'm happy to take questions at this time.