

National Council on Teacher Retirement

PRESERVING RETIREMENT SECURITY ACTUARIAL PANEL

Impact on Retirement Plan Design

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Public Pension Environment

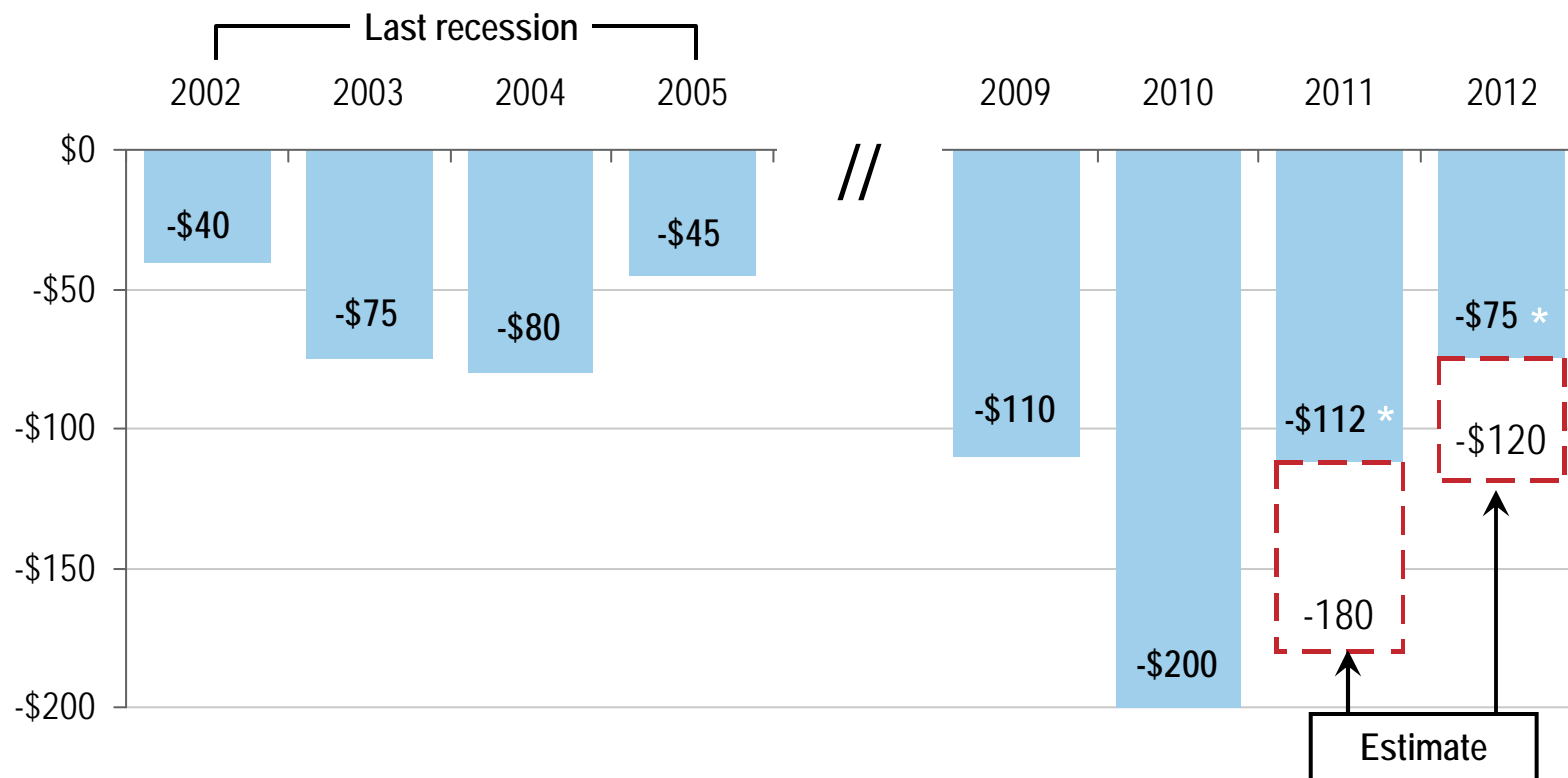
1. State and Local Government Budget Shortfalls
 - Federal money going away
 - Ripe for “downsizing” agenda
 - Fiscal conditions have caused plan participants to worry about benefit security
2. More Conservative State Legislatures
 - Limited experience with defined benefit plans
 - Term limits—no experience with government
3. Public Opinion
 - Pension envy
 - Perceptions of public workforce
4. GASB Proposed Changes
 - Volatile expense
 - Additional pressure for change



Public Pension Environment *continued*

State Fiscal Condition: How Bad Is It?

Total state budget shortfall in each fiscal year, in billions



* Reported to date.

Source: Center on Budget and Policy Priorities (2010). *State Budget Troubles Worsen*

Public Pension Environment *continued*

Media and...

- Print
- TV/Cable News
- Internet—Blogs
- Opinion Research
 - Pew Center
 - Manhattan Institute
 - Rauh—Kellogg
 - National Institute for Retirement Security



Potential Benefit Changes

Defined Benefit Changes— Larger Impact on Cost Savings

- Retirement eligibility
- Cost of living adjustments (COLAs)
- Benefit formula
- Increase in member contribution rates

Defined Benefit Changes— Smaller Impact on Cost Savings

- Anti-spiking
- Re-employment
- Final average salary period
- Cost of purchased service

Alternative Plan Designs

- Hybrid plans
- Defined contribution plans

Some movement toward sharing risk.

Benefit Changes *continued*

Summary of recent plan changes?

		Change	Approach
Contribution Rates	Employer	CA, CO, FL, IA, LA, MN, NJ, NM	<ul style="list-style-type: none"> • Raise contribution rates • Lower contribution rates
	Employee	CO, IA, LA, MN, MO, MS, VA, VT, WY	<ul style="list-style-type: none"> • Raise Contributions • Mandate contributions
COLA	New Hires	CO, IL, MI, MN, SD, UT, VA	<ul style="list-style-type: none"> • Suspension tied to funding or CPI
	Actives	CO, MN, SD	<ul style="list-style-type: none"> • Tied to funding percentage
	Retirees	CO, MD, MN, SD	<ul style="list-style-type: none"> • Delay start
Sponsor Contribution Rules		IA, NJ, VA, VT	<ul style="list-style-type: none"> • Additional contributions to ARC • Require ARC
Anti-Spiking		AZ, CO, IA, IL, NJ, VA	<ul style="list-style-type: none"> • Pensionable compensation • Longer FAS period • Longer vesting periods • Cap compensation growth in FAS period
Multiplier	New Hires	GA, NJ	<ul style="list-style-type: none"> • Lower multiplier
	Actives	VT	<ul style="list-style-type: none"> • Reduce longevity multiplier
Retirement Eligibility	New Hires	IL, MN, MO, MS	<ul style="list-style-type: none"> • Raise service requirements
	Actives	AZ, CO	<ul style="list-style-type: none"> • Eliminate combined age/service rule • Increase combined age/service rule
Retirement Age	New Hires	MO	<ul style="list-style-type: none"> • Raise normal retirement age
	Actives	AZ, CO, VT	<ul style="list-style-type: none"> • Coordinate with social security normal retirement age
Re-employment		CO, GA, IL, MI, MS, NM, SD, UT	<ul style="list-style-type: none"> • Eliminate service accrual after rehire • Suspend pension and health benefits based on earnings after rehire
Hybrid	New Hires	GA, MI, UT	<ul style="list-style-type: none"> • Combine Defined Benefit plan with a lower multiplier with Defined Contribution overlay • Choice of hybrid or Defined Contribution
Defined Contribution	New Hires	NJ, UT	<ul style="list-style-type: none"> • Part-time workers • Elected officials provided an employer match

Source: National Conference of State Legislatures—July 2010

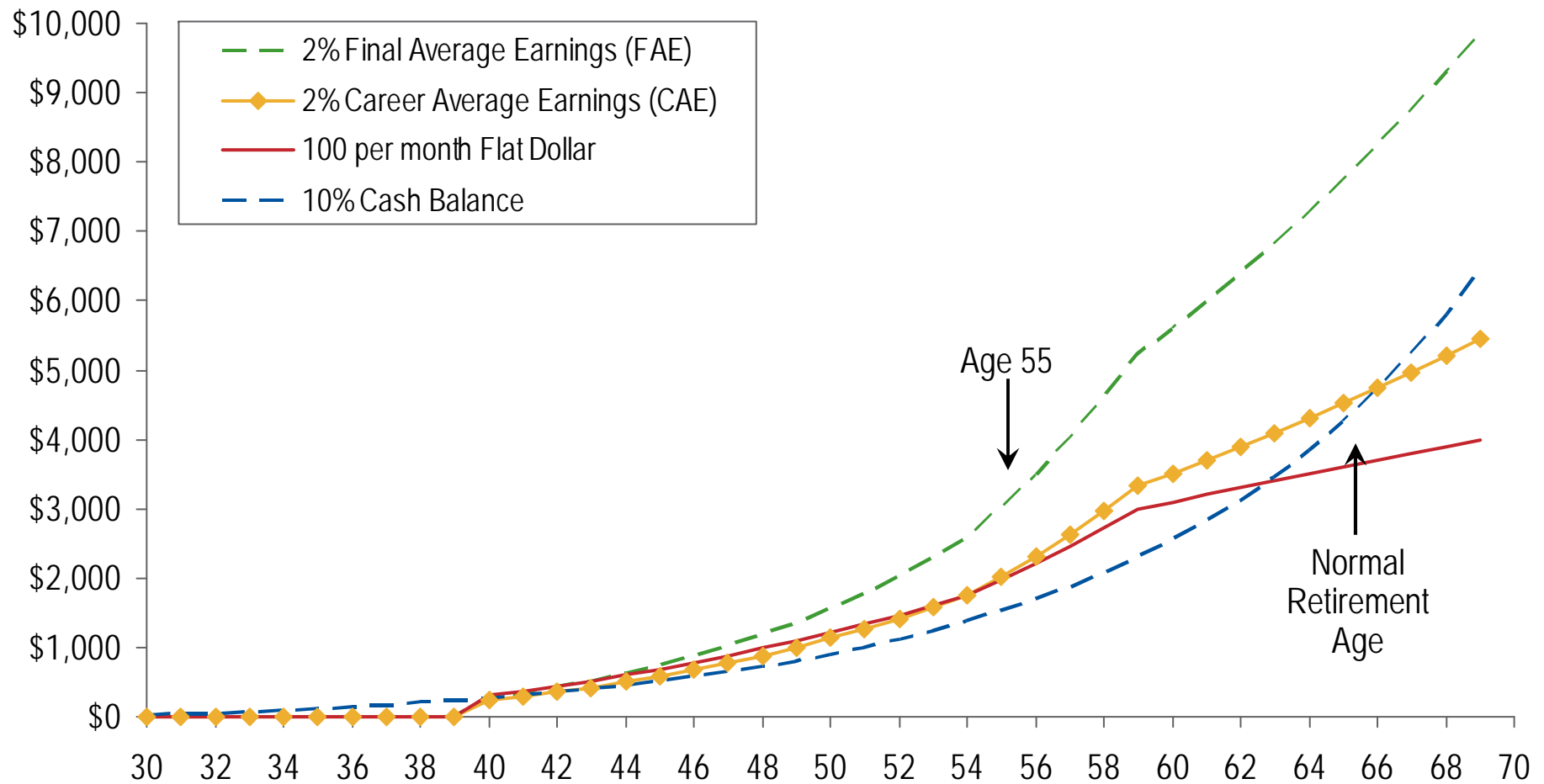
Risk and Features of Different Defined Benefit Plans

Defined Benefits Plan Designs

Type	Description	Example	Variations	Pros	Cons
1. Final Average Earnings (FAE)	Benefit based on a percentage of participant's average earnings during specified period	1.5% x Final 5-year Average Earning x Years of Service	May limit service or salary; Overall dollar limit	Benefit linked to salary growth; Keeps pace with Inflation	Back-loaded accrual/cost pattern
2. Career Average Earnings (CAE)	Benefit based on percentage of participant's average earnings over career	1.5% x Career Average Earning x Years of Service	May include inflation update; Layered accruals are common	Benefit partially linked to salary growth; Level accrual/cost pattern w/o updates	Does not keep pace with inflation; Increased administration
3. Flat Dollar	Benefit based on stated amount for each year of service	\$60 x Years of Service	May include inflation update; May limit service	Simplicity; Uniformity; Level accrual/cost pattern w/o updates	Benefit not linked to salary growth; Does not keep pace with inflation
4. Hybrid Plan (i.e., Cash Balance)	Benefit based on account balance that can be converted to annuity at retirement; Account balance determined similar to DC Plan	7.5% of annual earnings contributed to account; account balance grows 5% per year for interest	Contribution may vary by age/service	Benefit partially linked to salary growth; Keeps pace with inflation; Benefit defined in terms of account balance	Lack of familiarity; Administrative complexity

Risk and Features of Different Retirement Plans *continued*

Benefit Amount Payable for New Hire at Age 30; Salary = \$40K;
3% Salary Growth



Risk and Features of Different Retirement Plans *continued*

Employer and Employee Risk of Different Designs

	Defined Benefit										Defined Contribution	
	Flat Dollar		Career Average		Final Average		Hybrid		Lump Sum Options		401(a), 401(k), 403(b)	
	ER	EE	ER	EE	ER	EE	ER	EE	ER	EE	ER	EE
Economic Risks												
Investment Risk	4	1	4	1	4	1	3	2	3	3	0	4
Inflation risk	0	4	1	3	3	2	2	2	2	2	1	3
Contribution Risk	3	1	4	1	4	1	3	1	3	1	1	1
Longevity Risk	4	0	4	0	4	0	3	2	3	4	0	4
Non-Economic Risks												
Accounting Risk	3	0	3	0	3	0	3	0	3	0	0	0
Features												
Rewards older/longer service employees	4		3		3		2		2		1	
Planning Tool	2		2		2		1		1		1	
Hiring Attractiveness	2		2		2		3		3		3	

Risks	Features
0 None	Not applicable
1 Low	Minor importance
2 Somewhat low	Somewhat minor importance
3 Somewhat high	Relatively important
4 High	Very Important

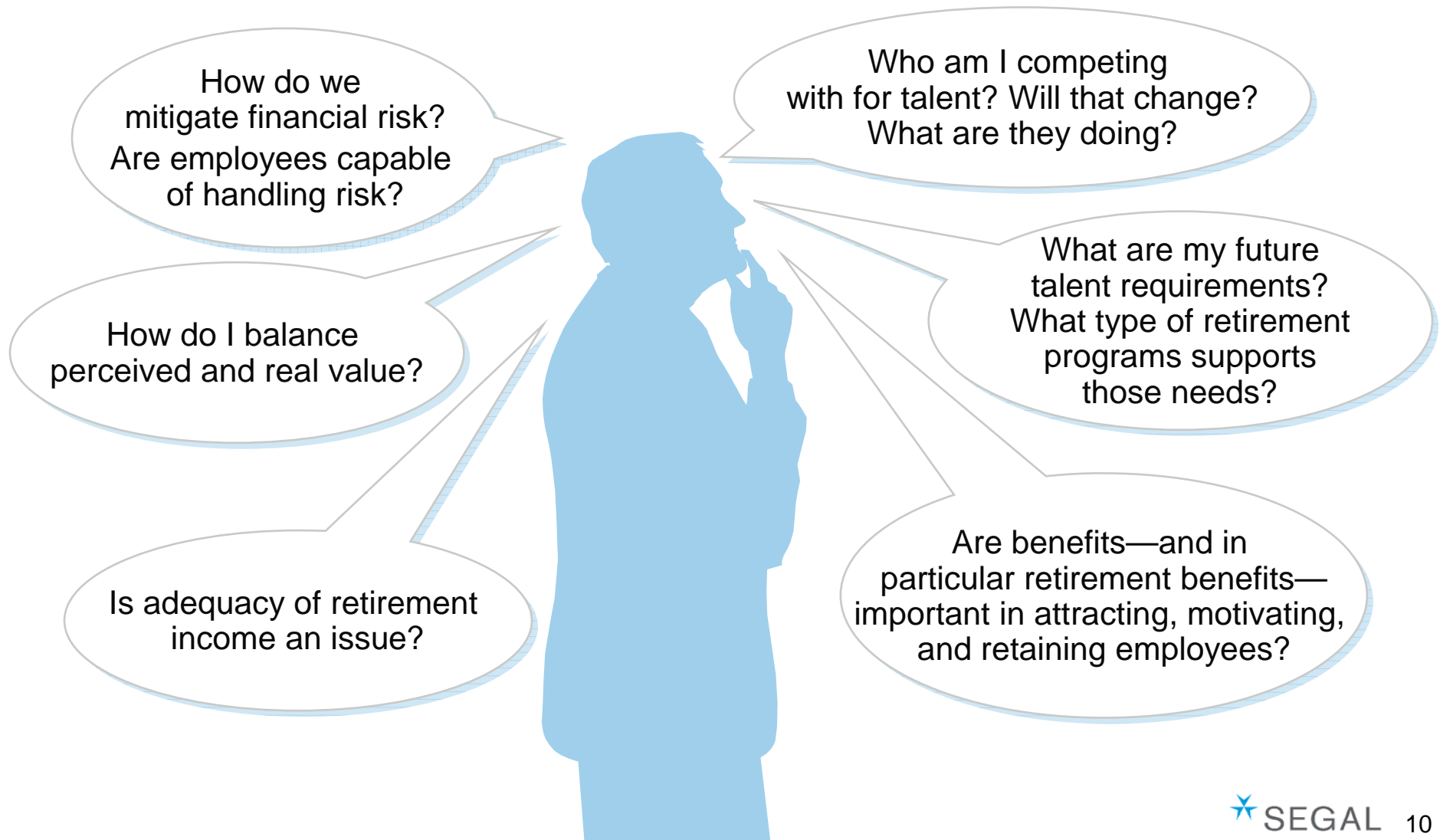
Plan Design Considerations

Assessing the Appropriateness of a Plan Design

- Assess risk components
 - Is risk in its proper place?
 - Can the risk be managed by the State?
 - Investment risk
 - Longevity risk
 - Short-term vs. long-term benefit risk (Is a short-term problem being solved at the expense of a long-term problem?)
- Measure against retirement philosophy
 - Adequacy at retirement (replacement ratios)
 - Level of benefit aligned with length of tenure
 - Purchasing power into retirement
- Measure against funding policy
 - Stability
 - Amount
- Analyze investment options
 - Sufficient number and variety
 - Sufficient safeguards

Plan Design Considerations *continued*

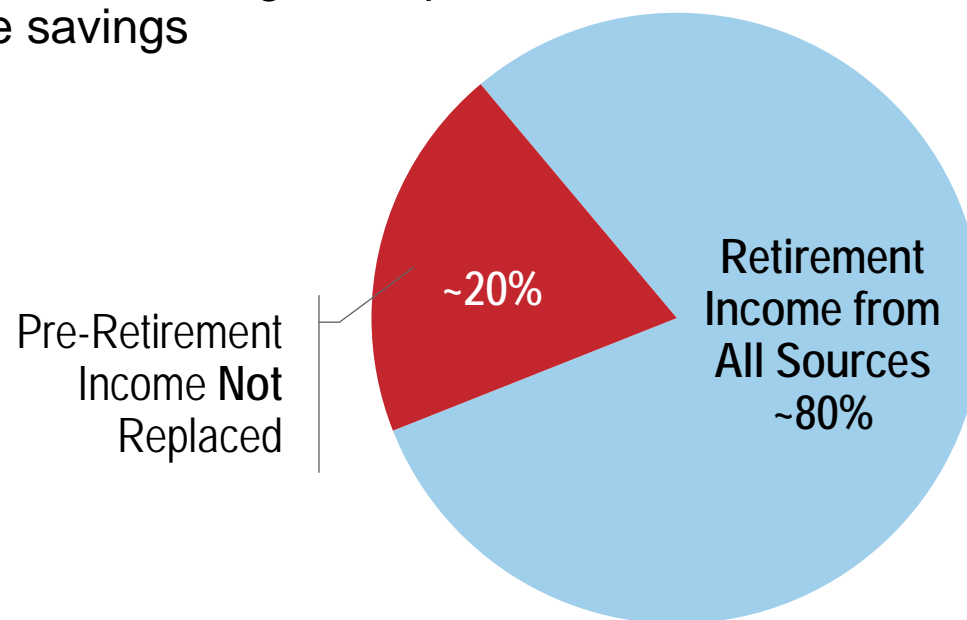
Considerations in Selecting the "Right" Plan



Plan Design Alternatives

Retirement Income Replacement Ratios

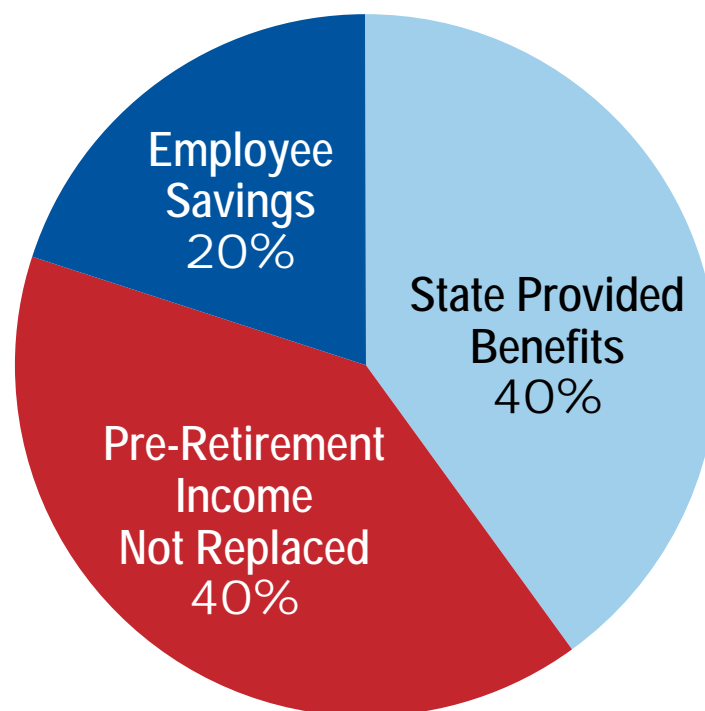
- A common approach used to analyze and compare retirement programs is to measure the relative income provided by the retirement plan as a percentage of the employee's final salary prior to retirement.
- Retirement Income Replacement Ratio ("Replacement Ratio")—measure of annual income provided at retirement to the employee's final salary prior to retirement
 - Includes income from all sources including State-provided retirement benefit, Social Security and employee savings
- Employees need between 78% to 94% of pre-retirement income ("replacement ratio") to maintain their standard of living during retirement



Plan Design Alternatives *continued*

Retirement Philosophy

Given a philosophy of sharing of retirement costs and an 80% target replacement ratio for employees (including income from all sources), the State's retirement benefit programs should provide a replacement ratio between **40% – 55%** for each employee after a full career



Thank You!



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