Actuarial Panel: Impact of Closing a Plan

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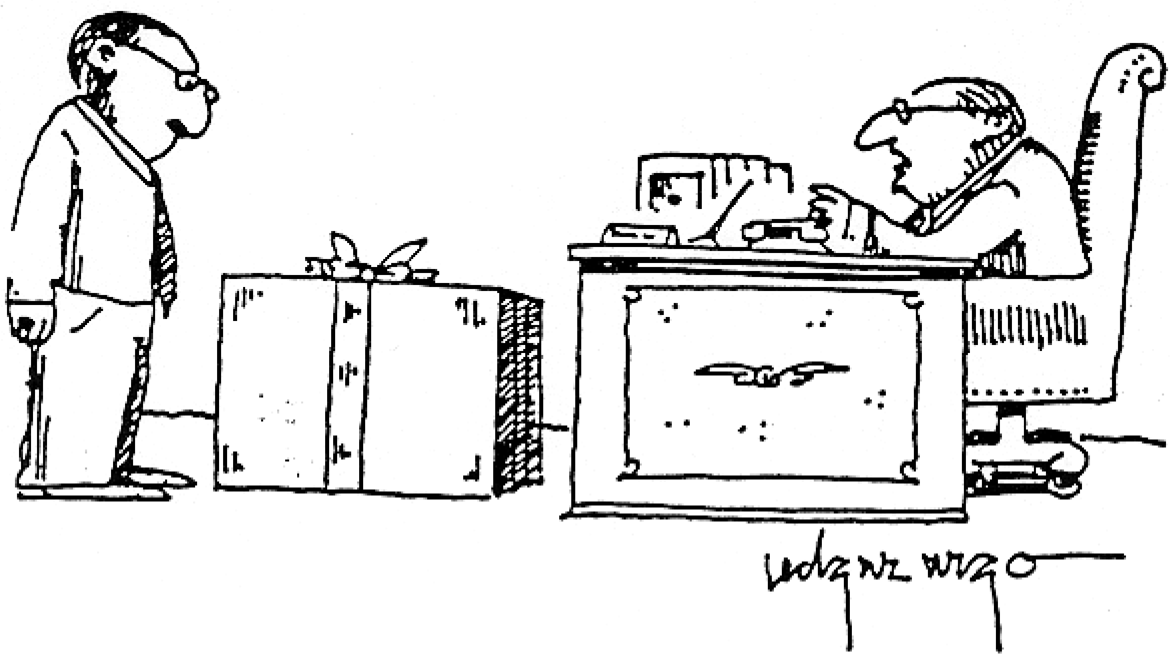
Plan Closure



How would you like to trade in your stuffy old DB plan for the new redesigned plan in that box?

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Overview

- Types of Retirement Plans
- History of Public Pensions
- Defining a “Closed” Plan
- Key Issues in Moving to a DC Plan
- Costs and Key Risk Areas
- Impact of Closure on the DB Plan

Types of Retirement Plans

- Defined Benefit Plan
  - % x Service x Final Average Pay = Monthly $
- Defined Contribution Plan
  - 401(a), 401(k), 403(b), 457, etc.
- Hybrid Plan
  - Cash Balance, Pension Equity
  - Smaller DB with DC side account
  - Various creative designs

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Brief History of Public Pensions

- Public pensions have been around at least since the time of the Magna Carta (1215)
- Appeared in the United States in the 19th Century. First for NYC Police in 1857
- Massachusetts established the first General Employee plan in 1911
- Became widespread by 1930 or so
- Original plans were mostly DC plans with an employer match

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History of Public Pensions

- Financial consequences of The Great Depression led to the introduction of defined benefit floors into plans that were previously pure DC plans
- It is not a coincidence that the Federal Insurance Contributions Act, providing a "floor of protection" to US workers was signed into law in 1935
- By about the mid 20th century, Defined Benefit Plans became the dominant type of Plan in the Public Sector

What Does “Closing” Mean

- All new entrants go into some other plan
- Maybe current employees can choose to go into the other plan for future service
- Maybe they are forced to do so
- There are also voluntary arrangements where people can choose among a DB, a DC, or a Hybrid Plan (not really “closing”)

Is It Really Closed?

- If, after the "close", all assets still back all liabilities, then there is only one plan with different tiers – plan was not really closed
  - Plan currently provides 2% multiplier with high COLA. All new hires get 1.5% multiplier with smaller COLA
- Otherwise, there is more than one plan, and the plan was really closed
  - If all new hires go into a DC plan, the DC assets cannot back the DB liabilities

Closed Plan Issues

- Best practices and current accounting standards call for accelerated funding in a closed plan. *Likely to increase plan sponsor costs near term.*
- Longer term asset allocation changes may lead to reduced investment return and therefore to *higher total costs for the plan sponsor*.

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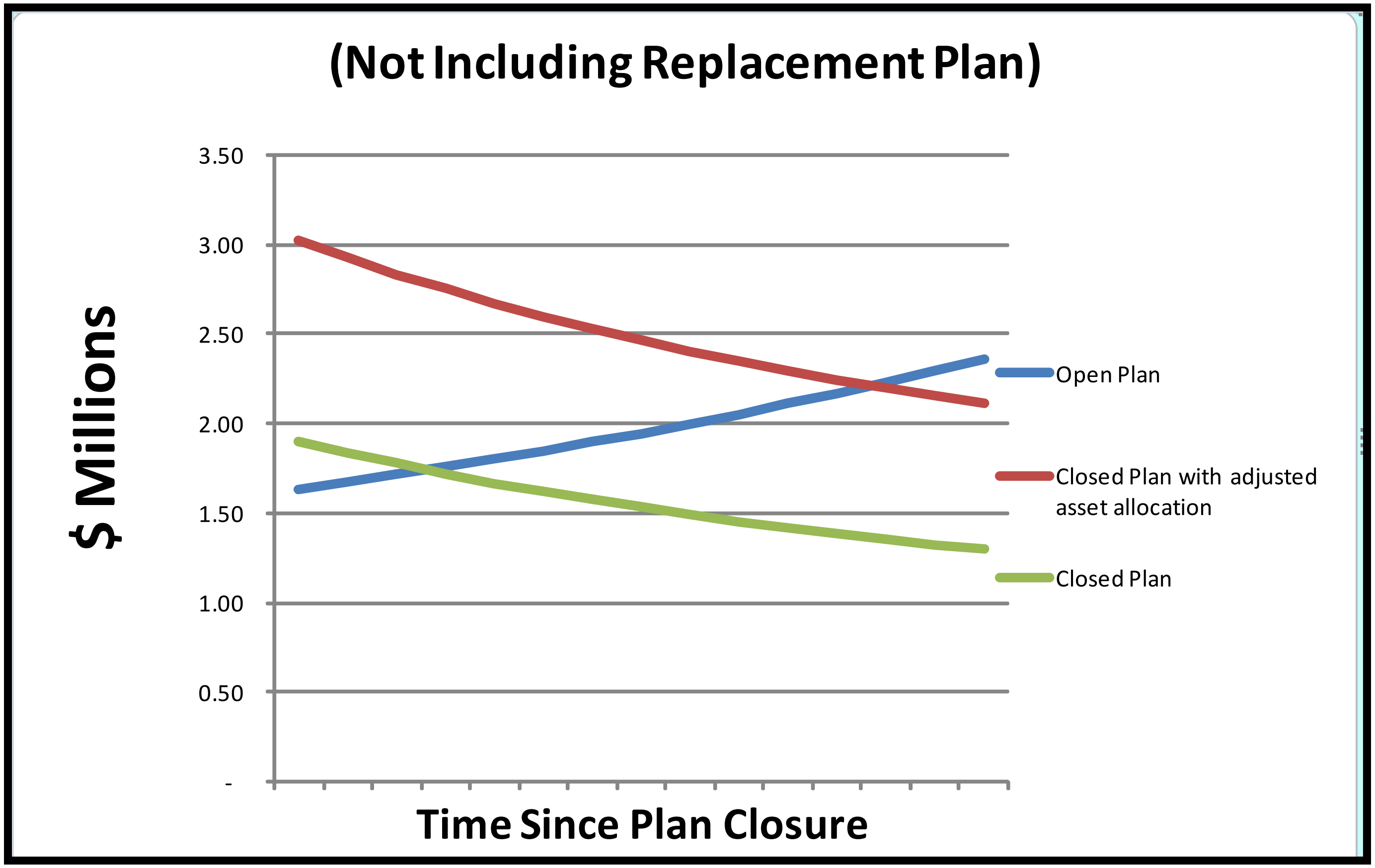
Pattern of Employer Contributions



In the open plan, contributions are usually level as % of pay, but rise in $ amount as the covered payroll goes up. The true crossover points would be much farther in the future than illustrated if replacement plan contributions were illustrated.

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Understanding the Pattern

- The green line results from accelerated funding but presumes assets can always be invested in a diversified portfolio. It goes down as the payroll goes down.
- The red line recognizes the effect of changing cash flow needs on asset allocation – a real and often ignored effect. It goes down as the payroll goes down.
- The blue line is the contribution pattern from the open plan. It is level as % of pay, but increases in $ as the payroll increases. This is the only line that includes funding for new hire benefits.
- Actual plan sponsor savings, if any, may be many years away depending on the replacement plan (which is not shown)

Replacing DB with DC

- Might appear to reduce cost, benefit reduction less obvious
- Investment, longevity, and inflation risk transferred to employees
- DC usually produces a much lesser benefit per $ of contribution than a DB plan
- As a result, retirees may have less to contribute to the local economy after the closure of the DB plan than before
- Retirees may even wind up on public assistance in some cases

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Replacing DB with DC

- If DC benefits ultimately prove to be inadequate, Government may eventually have to make up the difference and any savings that may have been realized could evaporate quickly
- Death and disability require separate treatment
- COLA can't really be provided
- What about employees who are not covered by Social Security?
- Issues with attraction and retention of employees

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Replacing DB with DC

- Higher DC plan administrative costs
- Mandated minimum DC benefit if not in social security
- Inflexibility of DC plan
- Changing liquidity requirements of a DC Plan as employee ages

Issues with Tiers

- May reduce cost, but *obviously* provides lesser benefits (or higher employee contributions)
- Expense of administering multiple benefit provisions
- Difficulty of determining who is in which tier
- New tier may float up to old tier anyway as new tier people become unhappy
- More new tiers may be created, exacerbating all of the above

Advantages of Tiers over Closure

- Death benefits, disability benefits, and COLAs can easily be accommodated in a new DB tier
- In many cases, assets in a tiered plan can be commonly invested
- Cash flow from second tier may be able to help with liquidity needs of first tier, resulting in a better asset allocation than is produced by a closure
- Actuary can present a unified funding pattern and potentially avoid or reduce the increases in contributions that an actual closure can produce

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Takeaways

- DB Plans provide much more in Benefits per Dollar of contributions than DC Plans
- Reduced benefits in replacement plan could lead to public retirees on public assistance
- Asset allocation changes in DB Plan after closure likely to lead to reduced investment earnings, and therefore to higher costs for plan sponsor than anyone thought initially
- *Plan closure or major redesign should be undertaken only after careful consideration of long term effects by all concerned parties*

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