Frequently Asked Questions

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Decisions, Decisions: Retirement Plan Choices for Public Employers and Employees

Q1. Why was this study conducted?

A: In recent years, a handful of states have begun to offer public employees a choice between a traditional defined benefit (DB) pension and a defined contribution (DC) accounts as their primary retirement plan. Given this backdrop, the goal of the paper was to provide answers to the following questions:

- When given the choice, what do public employees choose: the DB or DC plan?
- What happens when employees choose their own investments?
- Can employers choose to offer meaningful supplemental benefits to DC members?
- What are the implications of an employer choosing to change from DB to DC?
- What are the implications for risk sharing in each of the systems?
- Do employers give employees the chance to choose a second time?

Q2. What are the report's key findings?

A: For the seven state retirement systems that offer a choice between DB and DC plans, the study finds that public sector employees overwhelmingly select DB pensions over DC plans. The DB uptake rate ranges from 98 to 75 percent, with the percentage of new employees choosing DC plans ranges from 2 to 25 percent. More broadly, the report finds:

- DB pensions are more cost efficient than DC accounts due to higher investment returns and longevity risk pooling.
- DC plans often lack supplemental benefits such as death and disability protection. These can still be provided, but require extra contributions.
- A shift from DB to DC does not close funding shortfalls and can increase retirement costs.
- A "hybrid" plan for new employees in Utah provides a unique case study in that it has capped the pension funding risk to the employer and shifted risk to employees.

Q3. What state retirement systems were studied?

A: The seven plans offering DB and DC choice that were analyzed for the study include:

- Colorado Public Employees' Retirement Association
- Florida Retirement System
- Montana Public Employee Retirement Administration
- North Dakota Public Employees Retirement System
- Ohio Public Employees Retirement System
- State Teachers Retirement System of Ohio
- South Carolina Retirement Systems

Q4. How was the study conducted?

A: To conduct the study, the authors requested information directly from retirement systems that allow new hires to choose between DB plans and DC accounts. These systems provided the actual statistics of what percent of members have chosen each option. The authors also asked for other important provisions relating to benefits and contributions. Finally, each system reviewed their portion of our final report to ensure its accuracy. This primary source material provides a valuable insight into what really happens when public employees are allowed to choose between DB plans and DC accounts.

Q5. Who are the report authors?

A: Mark Olleman is a Consulting Actuary and Principal in the Seattle office of Milliman, Inc. He has been with the firm since 1990 providing actuarial services for Milliman's defined benefit clients from Alaska to Texas. He is a Fellow of the Society of Actuaries, a Member of the American Academy of Actuaries, and an Enrolled Actuary. He has a Bachelor of Science degree from Whitworth University in Mathematics and Chemistry.

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Q6: How many public sector workers have DB pension plans?

A: In 2008, 14.7 million active state and local government employees had DB pension coverage through their employers. While employees in the private sector have seen a drastic decrease in DB plan coverage, most public employees still participate in a DB plan.

A recent study by the Bureau of Labor Statistics (BLS) showed that whereas private sector participation in DB plans dropped from 76% of full time employees in 1986 to 24% in 2008, public employee participation in DB plans only dropped from 93% of full time employees in 1987 to 88% in 2008. The drop in private sector coverage can be attributed to an unfriendly regulatory environment, as previous NIRS research has found. It's also important to that this decline in private sector coverage has occurred despite Americans' desire for pensions to help relieve their retirement anxiety.

Q7. What role do pensions play for employers?

A: Research finds that DB pensions play an important role in the human resource strategies employers, particularly government employers, since DB pensions are an effective recruitment and retention tool. This is particularly important in an environment where public sector employees receive lower compensation than their private sector counterparts. Also, DB pensions remain the most cost-effective way for employers to fund a retirement benefit.

Q8. What are the differences between a DB pension and a DC account?

A: DB and DC plans are quite different. DB pension plans provide employees with a predictable monthly benefit for life. The monthly pension benefit typically is a function of the number of years an employee devotes to the job and the worker's pay. DB plans are pre-funded retirement systems meaning that employers—and, in the public sector, employees—make contributions to a common pension fund during each employee's career. These funds are invested by professional asset managers. The earnings that build up in the fund, along with the dollars contributed while working, pay for the benefits employees receive in retirement.

Unlike DB plans, there is no guarantee of a certain level of retirement income in a DC plan. Rather, employees (and usually employers) contribute to the plan over the course of a worker's career. Whether the funds in the account will ultimately be sufficient to meet retirement income needs will depend on a number of factors: the level of employer and employee contributions to the plan; the investment returns earned on assets;

whether loans are taken or funds are withdrawn prior to retirement; and the number of years retirees will live after they leave work.

Another difference is that DC plans are individual accounts with assets typically "participant directed," meaning that each employee can decide how much to save, how to invest the funds, how to modify investments over time, and how to withdraw funds in retirement.

Q9. How do DB and DC investment returns compare?

A: Research indicates the average employees directing their own investments tend to earn lower investment returns than DB plans, for a variety of reasons. In DB plans, assets are pooled and professionally managed; by pooling assets, DB plans drive down asset management and other fees. Also, DB plans have broadly diversified portfolios and managers who follow a long-term investment strategy. On the other hand, individuals in DC plans, despite their best efforts, often fall short when it comes to making good investment decisions. Towers Watson found that, between 1995 and 2006, DB plans outperformed DC plans by 1.09%, on average.

Q10. What are the costs associated with moving from a DB to a DC plan?

A: Some states around the country have looked to moving from a DB plan and placing all new hires into DC accounts, and found that such a move can increase retirement costs. This occurs for three distinct reasons.

First, DC plans do not have the economic efficiencies of DB plans. This drives up retirement costs. DB plans save money by pooling risks and achieving greater investment returns. According to one estimate, a DB plan can provide the same retirement income at about half the cost of a DC plan. Thus, when a DB plan is frozen and replaced with a DC plan, far greater contributions from both employers/taxpayers and employees will be required to maintain the same level of benefit in the DC plan.

Second, maintaining two plans is more costly than operating just one. State and local governments typically do not have the option of transferring current employees out of a DB plan and into a new DC plan. This means the employer will have to bear administrative costs for two plans, at least until the DB plan is finally phased out completely, a process that could take many decades as employees in the system complete their careers, retire, and ultimately die.

Finally, when a DB plan is closed, payments to amortize the unfunded liability for the DB plan may be accelerated, which increases short-term contributions and lowers long-term contributions. This is actuarially consistent with the DB plan's shorter future lifetime. The current GASB rules require this acceleration of unfunded liability payments to be recognized on financial statements, although not all plans determine their actual contributions according to the GASB rules.

These factors have influenced many states studying whether to switch from DB to DC. As a result, the vast majority have chosen to keep their DB plan, in the best interests of employers, taxpayers, and employees.

Q11. Can DC participants achieve DB returns?

A: Yes. In some choice states, DC members are able to earn returns competitive with the DB plan, but in order to do so they must forego the ability to choose their own investments.

For example, in Washington, there is an option to invest in the Total Allocation Portfolio, which mirrors the DB plan investments. There, 56% of DC members' assets are invested in the TAP. Oregon offers a similar program through its Individual Account Program, but in Oregon no other investment choices are offered.

Both the Washington and Oregon plans are "hybrid" DB/DC plans, in which employer contributions fund a DB plan, and employee contributions fund an individual account. This is significant because the DB plan provides some level of guaranteed income regardless of the account's investment returns.

Q12.Can employers offer meaningful supplemental benefits to DC members?

A: Yes. Death and disability benefits can be provided to DC participants, but these additional benefits require supplemental contributions that are not credited to members' DC accounts.

In Florida, disabled members can give up their DC balance and receive the DB plans disability benefits with the employer paying an additional .25 - 1.33% of pay. In Alaska, all new hires since July of 2006 only have a DC plan. The plan provides an occupational death and disability benefit of 40% - 50% of salary that is financed solely by employer contributions.

Q13. What about do-overs?

A: Some states offer a "do-over" option, in which employees can change their choice at some point. But the take up rate for this option is small.

Five plans offer some sort of "do-over." In both Florida and Ohio, small percentages of employees have chosen to take the do-over options since they've been offered, in 2002 and 2003 respectively.

This suggests that the majority of public employees, at least in these states, are happy with their initial retirement plan choice.

Q14. What are the implications for risk sharing in each of the systems?

A: Generally, employers take most of the risks in DB plans and employees take most of the risks in DC plans. For example, in traditional DB plans, employers take on all of the funding risk; that is, if an unfunded liability in the pension plan develops, the employer is solely responsible for filling that funding gap. Of course, employees may indirectly take on some of that risk, for example, through increased employee contributions or decreased benefits. But the legal and fiduciary responsibility to pay down the unfunded liabilities remains with the employer. Under DB plans, employers are largely responsible for funding risk and longevity risk. Under DC plans, on the other hand, the funding risk, inflation risk, and longevity risk is solely assumed by employees.

Q15. How is the new Utah hybrid plan different?

A: Beginning in July 2011, employees hired in Utah get to choose between either a hybrid plan, with both a DB pension and a DC account, or a DC only plan. Regardless of the employee's choice, the employer will contribute 10% of pay. The DB plan is only projected to cost 7.5% of pay. Any portion of the 10% of pay employer contribution not used to fund the DB plan will be deposited in the employees DC account. However, if the 10% of pay employer contribution is insufficient to fund the benefits in the DB plan, employees choosing that option will have to make up the difference through automatic payroll deductions. Alternatively, if employees choose the DC-only plan, the employer will contribute 10% of salary to the employees' DC account.

The Utah design allows employees a unique decision: in order to get the advantages of a DB pension—including a guaranteed benefit for life, professional investment management and the larger benefits provided by longevity pooling—they must also take on the funding risk. If the employee chooses the DC plan, the employer will contribute 10% of pay to the DC account. If the employee chooses the hybrid plan, the employer will contribute 10% of pay, as described above. In other words, regardless of which plan an employee chooses, and regardless of investment returns, the employer contribution remains a flat 10% of pay.

What differentiates Utah is a large shifting of risk from the employer to employees. If another market downturn occurs, the employers' contributions for new hires will remain 10% of pay. The employees in the hybrid plan will absorb the risk through a combination of smaller deposits to their DC accounts, as well as possible payroll deduction.