

Media and Interested Parties Webinar

On the Right Track?

State Pension Reforms in the Aftermath of the Financial Crisis

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NATIONAL INSTITUTE ON
Retirement Security

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Agenda

- Welcome and Introductions
- Report Overview
- Detailed Findings
- Conclusions
- Q&A



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Why We Did This Study

- Follow-up on NIRS' 2008 “Look Before You Leap.”
- What changes happened in private sector pensions? Understanding why such shifts occurred is important. Does this make sense for public employers?
- 45 states passed pension reform since 2008
- Revisit cost and workforce implications of DB to DC switch in light of those reforms of public pensions.



Primary Findings

- Forces behind the overall private DB-DC shift do not necessarily apply to governments.
- DB pensions persist among largest employers.
- Closing or freezing DB pensions and switching to DC accounts do not address underfunding and entails significant costs.
- Most states are modifying existing DB pensions to ensure long-term sustainability.



Secondary Findings

- Pension freezes and DC shift threaten workers' retirement security, hardest on mid-career employees.
- Pensions balance public sector compensation with the private sector, boost retention and productivity → high quality services for a lower cost over the long-term.
- Shift to DC likely to hurt recruitment and retention of skilled workers, or cause increases in other compensation.



Terminology

- “**Closed**” DB plans: no new entrants
- “**Frozen**” DB plans: closed plans with future benefit accrual reduced/eliminated for existing workers
 - “**Hard freeze**”: no further benefit accruals for anyone; benefits frozen in terms of service credits and pay.
 - “**Soft freeze**”: allows continued benefit accrual for at least some employees, usually with a reduced benefit formula.

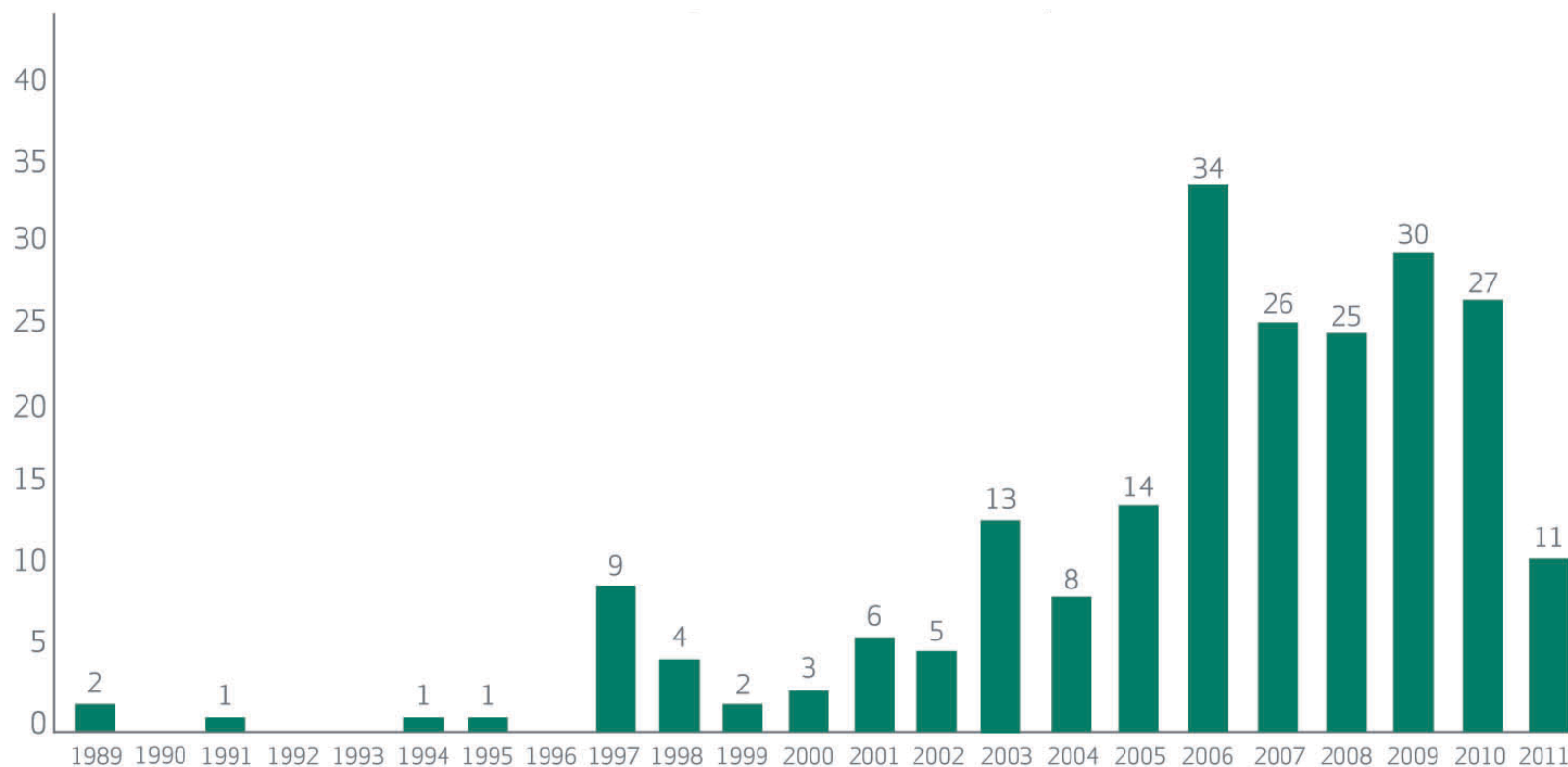


Why Private Employers Froze DB Pensions and Shifted to 401(k)s

- Onerous funding regulations on private pensions and FASB accounting rules caused funding volatility
- Changes in technology and industrial makeup of economy
- Shift from internal labor markets to flexible labor markets, insecure employment
- Corporate objective to maximize shareholder value



Fortune 1000 Companies Pension Freezes, 1989-2011

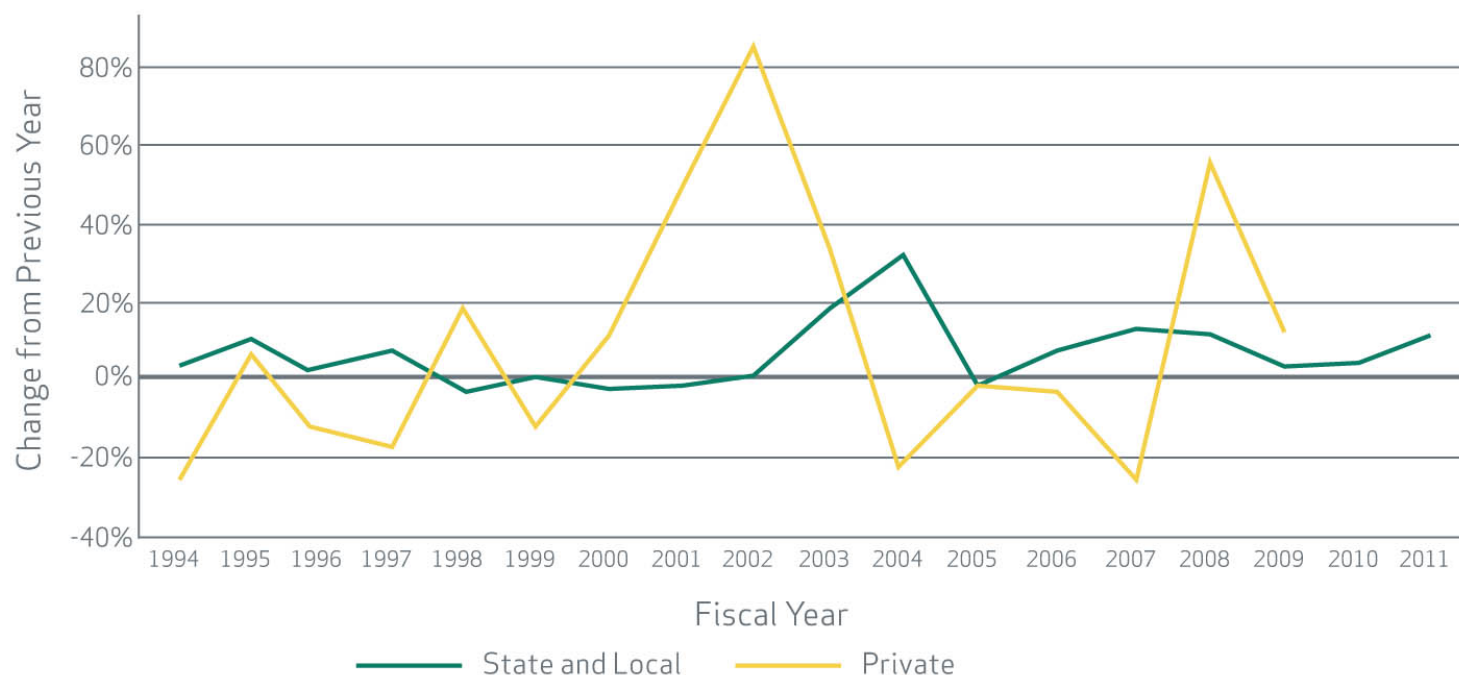


Source: Adapted from McFarland 2011, Figure 2.



Funding of Private DBs is More Volatile than for Public Pensions

Annual Change in DB Pension Contributions, 1994-2011

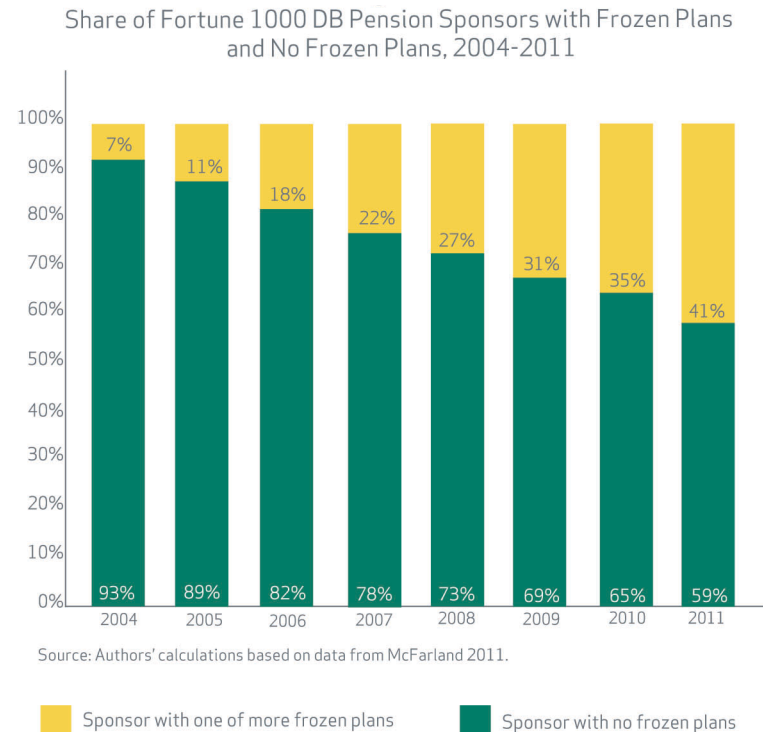


Source: Munnell et al. 2006; Annual Survey of State and Local Pensions; and Department of Labor Form 5500.
Note: Private sector data not available for 2010 and 2011.



Many Private Sector Employers Remain Committed to DB Plans

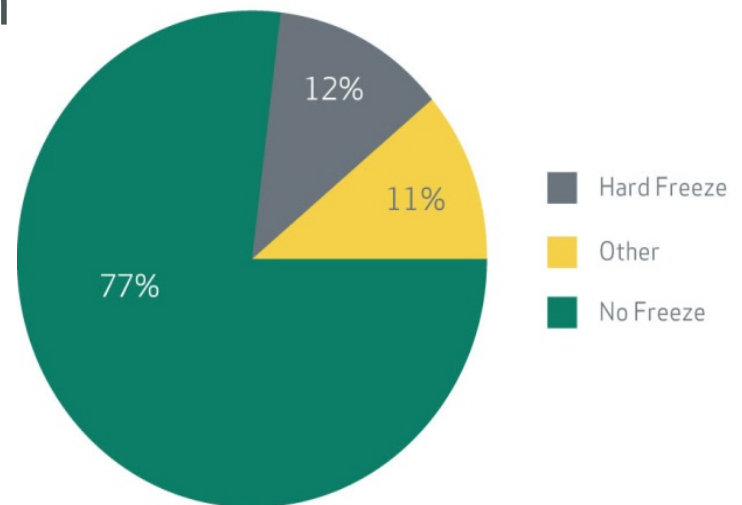
- “Many employers remain committed to providing these plans as an important part of their compensation package.” (U.S. Chamber of Commerce: *Retirement Benefits in the 21st Century*)
- Three-fourths of active DB pensions report “DB plan aligns with our total rewards philosophy” (AonHewitt: “Global Pension Risk Survey 2011: US Survey Findings,”)



Three-Fourths of Private Sector DB Participants Are in Active Plans

- 9.4 % of employers with 10,000 participants or more stopped all employees from earning new benefits in 2007. (GAO 2008).
- Of the Fortune 1000 companies with DB pensions, half had no closed or frozen plans in 2010. (Towers Watson)

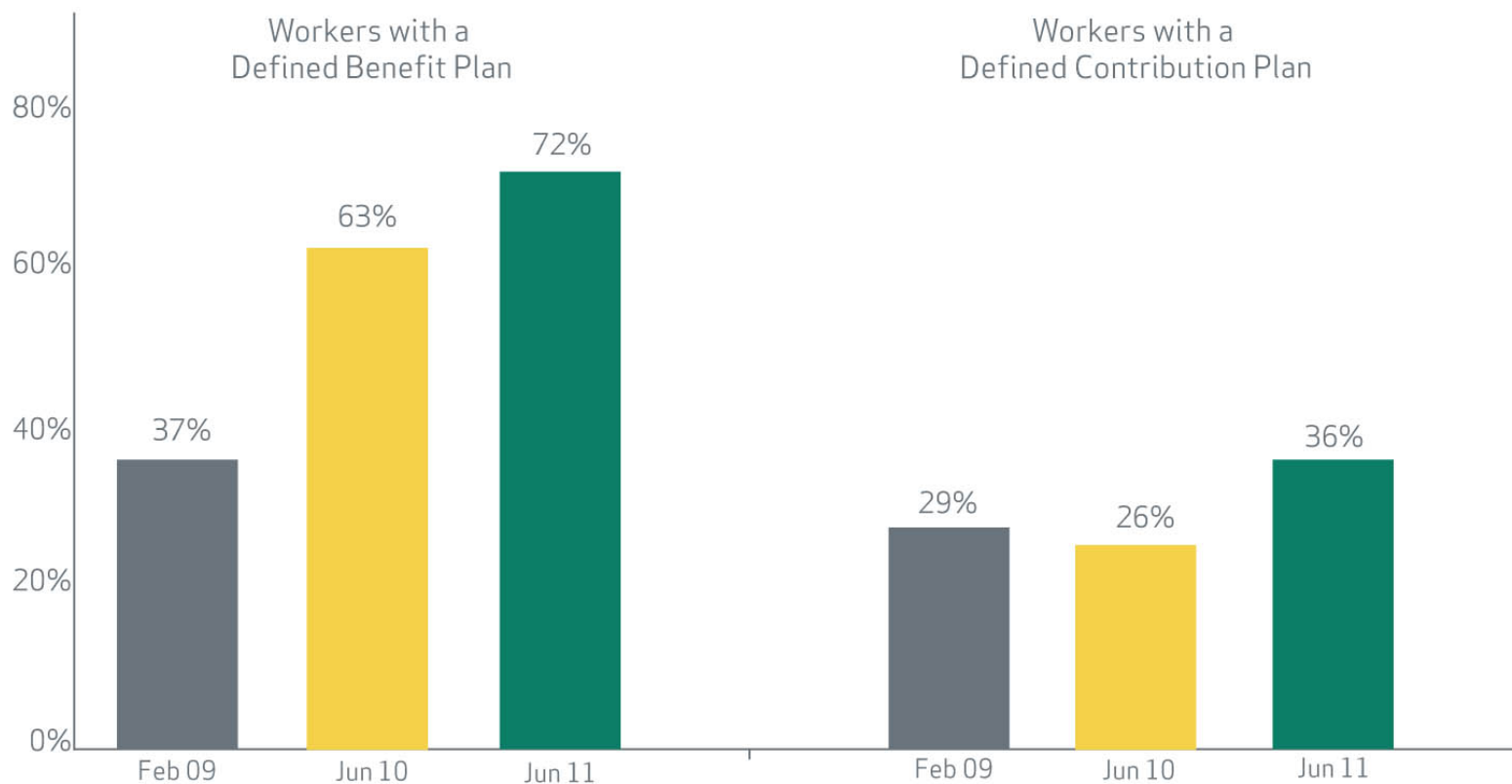
When Discussing Prevalance of Plan Freezes, Looking at Number of Plans can be Misleading



Source: PBGC, Based on Premium Data Received as of February 1, 2012.



Share of Workers under 40 Reporting that Retirement Benefit is Important Reason for Staying with Employer



Source: Adapted from Nyce 2012, Figure 6.



Public Sector Difference

- Commitment to stable employment relations and internal labor markets.
- Ability to smooth out the effects of business cycles on funding requirements to a greater degree.
- Public interest mission: use DB pensions to help provide high quality public services in a cost effective manner, while also providing retirement security.
- Public employers have more in common with the largest private employers, who are more likely to keep DB pensions.



Public Pension Reforms After 2007-8 Financial Crisis

- 45 states have passed pension reform since 2008
- Vast majority have modified their existing pension plans. Most common:
 - increased Employee contributions;
 - reduced DB benefits for new hires, including higher retirement age
 - Cost of Living Adjustment (COLA) reductions for retirees and existing workers.



State reforms, cont'd

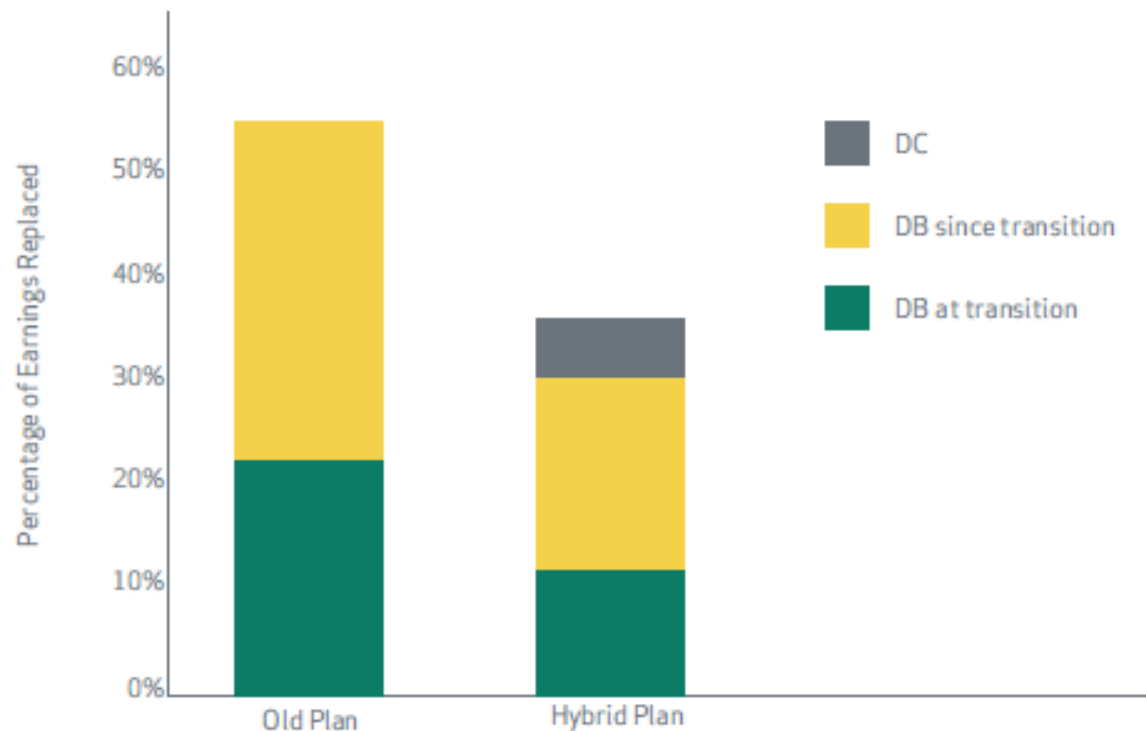
- No state has shifted to a DC-only plan since 2005.
- Some mandatory hybrid arrangements, most for new hires only
- Only RI recently enacted real “freeze”
 - Existing employees placed into hybrid plan, with reduced benefit



Impact of Freezes on Mid-Career Workers: Rhode Island Hybrid

Defined Benefit vs. Hybrid Plan Benefits

Typical Rhode Island Teacher, Age 45 with 13 Years of Service, Planning to Retire at 62



Source: Adapted from Fomia 2011.

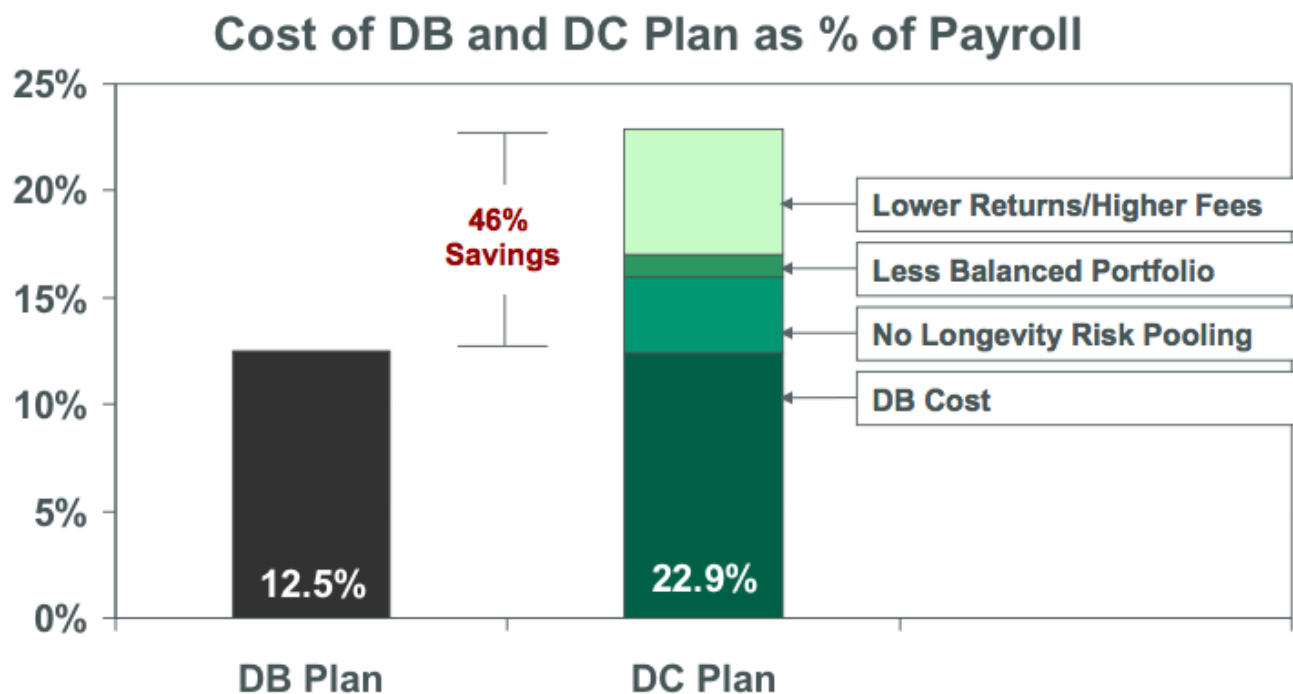


Cost Implications of Public Employer Shift of Retirement Benefit Design

- Cost efficiency of DB vs. DC
- Transition costs from closing DB plans



Cost Efficiency of DB vs. DC



Conversely, DC system costs 83% more than DB system to fund comparable retirement benefit.



Closing a DB Plan Increases Costs

- Accelerated amortization of unfunded liability
- Shorter investment horizon, greater liquidity needs
 - Shift in asset allocation
 - Lower investment returns
 - Higher contribution requirements



GASB ARC is out and funding is always a policy decision, but...

- Accepted actuarial and investment practices still hold
- Funding principles being drafted by consortium of national associations of state and local leaders (Big 7)
 - Timely and responsible funding of pension obligations
 - Annual contributions should be reasonably related to the cost of each year of service (i.e., intergenerational fairness)



Minnesota Statewide Retirement Systems on DC Switch

- Medium term cost decrease; dramatic short term cost increase.
- Long term: DC plan less efficient than existing DB in cost-benefit terms
- \$2.8B transition cost, mostly from accelerated amortization of unfunded liabilities

Retirement Plan Design Study



6/1/2011

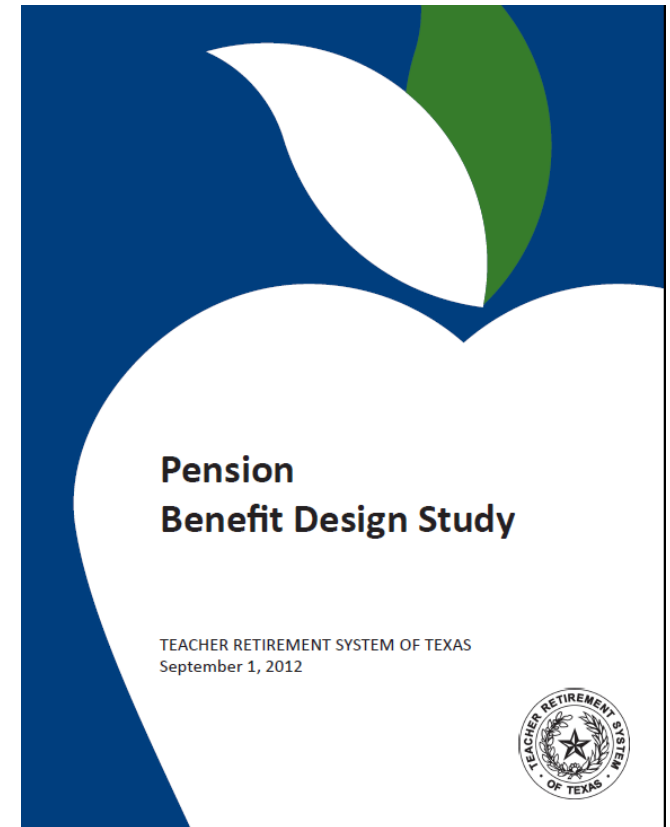
Minnesota Statewide Retirement Systems



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Texas Teachers Retirement System Study on Plan Options

- \$11.7 billion/49% increase in closed DB plan liability due to a more liquid asset allocation
- Cost comparison on multiple plan design options
 - **DC: most expensive**
 - **DB: least expensive**



TX, cont'd

- Simulations to realistically measure probable outcomes for workers in DC system:
 - lower returns
 - higher fees
 - market volatility
- Workers would have only a **50% chance** of reaching **60% of the benefit** provided by the DB plan, **at the same cost.**



Conclusion

- Private sector retirement benefits pathway is not necessarily right for public employers.
- Strong evidence that it's less costly to adjust pension benefits than to shift to DC.
- So far, state governments have favored modifications to existing DB plans aimed at short- and long-term sustainability, rather than abandon this valuable HR tool.



Questions?



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