NEW Research

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

Webinar
August 23, 2017
Agenda

• Logistics & Introductions
• Research Review
• Q&A
Webinar Logistics

• Attendees in listen only mode.

• Research, supporting materials at nirsonline.org.

• Questions welcome. Type question using “Question” function on control panel, and we will answer.

• Encourage distribution of information - @nirsonline #pensions

• Audio, technical issues during webinar, please call contact GoToWebinar at 1-800-263-6317.

• Recording & replay of webinar will be available.
Speakers

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Consulting Actuary  
Milliman
Why This Study

• Update on trends from 2011’s report.
• Public employee participation in defined benefit (DB) plans remains strong.
• Since 2010, only a handful of states enacted pension reforms with defined contribution (DC) components and only two included employee choice options.
• This year, some states enacted changes with DB/DC plan choices.
Six Key Findings

1. When given the choice between a primary DB or DC plan, public employees overwhelmingly choose the DB pension plan.

2. DC plans are less cost efficient than DB plans due to:
   – lower investment returns
   – lack of longevity risk pooling
Six Key Findings (continued)

3. Some states have considered moving from a DB to DC plan in an attempt to address unfunded liability. Making this shift does not close any existing funding shortfalls and can increase retirement costs.

4. DC plans typically lack supplemental benefits like death and disability. Some plans attempted to provide these benefits, but they require extra contributions.
Six Key Findings (continued)

5. In systems where the design of the plan options encourages selection of a DC plan, employees still predominantly choose a DB plan.

6. Even though some states offer a “do-over” option, take-up is rare.
Identified systems that offer a choice between a plan with DB benefit and DC only:

- Colorado PERA
- Florida Retirement System
- Michigan PSERS
- Montana Public Employee Retirement Administration
- North Dakota PERS
- Ohio PERS
- STRS of Ohio
- South Carolina Retirement Systems
Methodology (continued)

- Requested information directly from systems that allow new hires to choose between DB and DC.
- Systems provided the actual statistics of what percent of members have chosen each option.
- Also gave details on provisions relating to benefits and contributions.
Finding #1: Public Employees Overwhelmingly Choose a DB Plan

- Misperception that DC plans more attractive to new employees than DB plans.
- NIRS 2017 public opinion polling finds opposite.

Figure 15: Americans overwhelmingly maintain a favorable view of pensions.

How would you describe your overall view of traditional pension plans?

- Favorable
- Unfavorable
- Don't Know/Refused

<table>
<thead>
<tr>
<th>Year</th>
<th>Favorable</th>
<th>Unfavorable</th>
<th>Don't Know/Refused</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>82%</td>
<td>11%</td>
<td>6%</td>
</tr>
<tr>
<td>2015</td>
<td>83%</td>
<td>13%</td>
<td>4%</td>
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<td>2013</td>
<td>83%</td>
<td>13%</td>
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<td>15%</td>
<td>4%</td>
</tr>
<tr>
<td>2009</td>
<td>87%</td>
<td>11%</td>
<td>2%</td>
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</table>

Source: NIRS, 2017 (Feb.), Pensions and Retirement Security 2017: A Roadmap for Policy Makers
Finding #1: Public Employees Overwhelming Choose a DB Plan

Figure 3. Total DB Elections over the Ten Years Between 2006 and 2015

Please see the Technical Appendix for detailed information on each state's take-up rates over time.
Example: Washington PERS & TRS Election for DB Option v. Default

Figure 2. Washington State Plan Employee Elections for DB Plans (PERS 2 and TRS 2) and Combination Plans (PERS 3 and TRS 3)

<table>
<thead>
<tr>
<th>Year</th>
<th>PERS 2 active enrollments</th>
<th>PERS 3 active enrollments</th>
<th>PERS 3 default enrollments</th>
<th>TRS 2 active enrollments</th>
<th>TRS 3 active enrollments</th>
<th>TRS 3 default enrollments</th>
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<tbody>
<tr>
<td>2002</td>
<td>64%</td>
<td>18%</td>
<td>18%</td>
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<td>2003</td>
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<td>2004</td>
<td>63%</td>
<td>17%</td>
<td>19%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>64%</td>
<td>17%</td>
<td>19%</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2006</td>
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<td>17%</td>
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<tr>
<td>2008</td>
<td>62%</td>
<td>17%</td>
<td>20%</td>
<td>42%</td>
<td>37%</td>
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<tr>
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<td>14%</td>
<td>23%</td>
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<tr>
<td>2012</td>
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<tr>
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<td>23%</td>
<td>55%</td>
<td>35%</td>
<td>19%</td>
</tr>
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</table>
Finding #2: DC Plans Are Less Cost Efficient than DB Plans

• Previous NIRS research indicates that DC plans are less cost efficient than DB plans because DC accounts have:
  
  – higher expenses;
  – reduced investment returns because of individual investor decisions; and
  – inability to maintain an optimal investment allocation over time.
Finding #2: Less Cost Efficient than DB Plans Due to Expenses

- Higher asset management fees
  - Boston College researchers found public DBs have an average of 43 basis points for asset management fees, compared to 97 points for DCs.
  - DC accounts experience 40 - 45 basis points fee disadvantage compared to DB.
Finding #2: Less Cost Efficient than DBs Due to Lower Returns

• DB plans benefit from professional asset management.

• **Morningstar**: Individual investment decisions in DC accounts drag down returns.
  
  • Individual returns over the 10 years ending in 2012 lagged behind professionally managed fund returns by 95 basis points and 249 basis points for the 10 years ending in 2013.
  
  • Flows in before prices fell; flows out before prices rise.
Finding #2: DC Less Cost Efficient Due to Investment Allocations

- **Still a Better Bang for the Buck**: DBs have much longer investment horizon than individuals, so DBs take advantage of optimal, balanced, portfolio.

- DC plans use target date fund (TDF), which gradually shifts to more conservative asset allocation as the worker ages. DC plan targets lowest investment return when it has the most money.
Examples of DB Advantage:

Nebraska: 11% return in DB vs. 6-7% return in DC from 1982-2002.

West Virginia: DB returns were 1.6% higher annually than DC in 2001-2010.
Examples of DC Plans with DB Investment Options

Washington State Plan 3: Ability to invest in the Total Allocation Portfolio (TAP), which mirrors investments in state DB.

Oregon Public Service Retirement Plan: All employee contributions invested in state’s Individual Account Program (IAP), which mirrors investments in state DB.
Finding #3: Death & Disability Is Provided to DC Participants

In Florida:
- Disabled members can surrender DC balance at time of disability and receive same disability benefits provided by DB.
- Occupational death benefits mirror DB.
- Financed by a separate charge that varies by employee type.

For Alaska: DC-only new hires since July 2006
- Plan provides occupational death and disability benefit of 40% of salary for general members and 50% for police/fire.
- Financed by employer.
Finding #4: Moving from DB to DC Can Increase Costs

• Faced with funding gaps, some states look to switch from DB to DC.

• Switch change can increase costs:
  – DC plans do not have same economic efficiencies as DBs.
  – Maintaining two plans is more costly than operating one.
  – When DB plan closed, payments to amortize the existing unfunded liability may be accelerated.
Example of Increased Costs

West Virginia Teachers:

- In 1991, closed DBs and placed all new teachers into DC.

- By 2003, state found that:
  - Unfunded obligations not reduced.
  - DC investment return lower.
  - 4,500 members who transferred to DC found it hard to retire.

- In 2005, all new hires moved back to DB and state projected $1.2 billion savings over next 30 years.
Finding #5: Employees Choose DB, Even If State Encourages DC

Utah Retirement System (URS):

- July 2011, URS offered new employees choice between DC-only plan and combination DB/DC.
- Each choice appears straightforward, but the sharing of the funding risk for the DB benefit could discourage some employees from the choosing the combination plan and thus encourages more employees to select DC.
Finding #5: Utah Employees Choose DB, Even If State Encourages DC

- DC Only Plan:
  - 10% employer contribution
  - No mandatory employee contribution

- Combination Plan:
  - 10% employer contribution
  - No mandatory employee contribution, unless the 10% employer contribution is insufficient to actuarially fund DB plan.
Finding #5: Employees Choose DB, Even If State Encourages DC

- Utah’s public employees must decide: do they choose DB/DC plan, and potentially have to contribute to the DB plan, or select DC plan?

- In 2015, 80% of new employees chose DB/DC plan. Over the years, 20% to 25% of employees have selected the DC-only plan.

- Risk sharing tradeoff: employees bear some funding risk in the DB/DC plan, employees bear all of the investment risk in the DC plan.
Finding #5: Employees Choose DB, Even If State Encourages DC

Florida Retirement System (FRS):

- Since 2002, new employees to FRS had choice between DB and DC.

- From 2002 to mid-2011, approximately 25% of employees chose the DC plan each year.

- After Florida Legislature decreased benefits of DB in mid-2011, an additional 5% of employees elected the DC plan.
Finding #6: Some States Offer “Do-Over” and Take-Up is Rare

- Colorado PERA, Ohio PERS and FRS allow members some form of do-over.

- FRS – Just under 700,000 members each year have an opportunity for a do over, only 84,400 have utilized it since 2002.

- Ohio - Out of over 650,000 eligible members, only 1,623 opted for a do-over since 2003.
Implications

• Public employees overwhelmingly choose a DB when given choice between DB or DC.

• DB plans more cost efficient than DC plans – because of higher investment returns and longevity pooling.

• In Washington State, majority of new employees actively choose the DB only plan over the default

• West Virginia employees with only the DC plan overwhelmingly chose the DB plan when offered.
Implications (continued)

- Shift from DB to DC does not close funding shortfalls and can increase costs.

- DC plans lack supplemental benefits like death and disability protection. Employers have attempted to provide these benefits, but these provisions require extra contributions not deposited to DC account.

- Utah and Florida provide unique case studies where legislatures have encouraged DC plans, yet a majority of employees still elect for combination or DB plan.
Conclusions

- The experience in public sector indicates that public employees highly value DB pension benefits.
- DB pensions remain most cost-effective way to fund a retirement benefit.
- Suggests public sector is unlikely to mimic the trend away from DB pensions like the private sector.
Questions?

National Institute on Retirement Security
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