

# Change Plan 2/3 Default

## Description of Issue

New employees who have never previously established membership the Public Employees' Retirement System (PERS), Teachers' Retirement System (TRS), and the School Employees' Retirement System (SERS) have 90 days to choose whether to become a permanent member of Plan 2 or Plan 3. If no choice is made within this time period, the new employee becomes a member of Plan 3 by default.

Stakeholders have requested that new employees who fail to choose between Plan 2 or Plan 3 should become members of Plan 2 by default.

## Recent Activity on this Issue

The SPCPP studied changing the Plan 2/3 default in the 2008 Interim. The Committee studied options for determining which plan should be the default plan and evaluated whether all Plans 2/3 should be changed, or just PERS at this time. Ultimately, the Committee recommended changing the default plan from Plan 3 to Plan 2, and just for PERS.

Bills to implement the SPCPP proposal were introduced in the 2009 Legislative Session but did not pass the Legislature (HB 1722/SB 5307). The House bill passed the House but neither bill was heard in the Senate Committee on Ways & Means.

## Other Materials Included

- ❖ 2008 SPCPP Executive Summary and Issue Paper.
- ❖ Bill draft of HB 1722 from 2009 Legislative Session.

## What is The Next Step?

The Committee will have a work session on this issue at the November 17, 2009 meeting.

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# Change Membership Default For Plans 2/3

## Description Of Issue

The SCPP considered the plan choice default in the Plans 2/3 of the Public Employees' Retirement System (PERS), Teachers' Retirement System (TRS), and the School Employees' Retirement System (SERS). A member requested that new employees who failed to choose between Plan 2 or Plan 3 to become permanent members of Plan 2 by default. The current default plan is Plan 3.

This request raises two immediate policy questions:

- ❖ Should the plan default be changed, particularly at this time?
- ❖ If so, how should the default be determined?

## Policy Highlights

- ❖ Have the values changed that made the Plan 3 design the policy preference for the default plan?
- ❖ There may be issues with changing the default at this time.
  - Legal considerations.
  - Financial market conditions.
- ❖ If policy makers don't have a policy preference for continuing the Plan 3 default, how should they decide which plan should be the default?
  - Look at historical data of plan choice preference?
  - Determine which plan best serves the needs of new employees?

## Policy Options For Changing Membership Default

Policy makers who wish to change the membership default may consider the following options:

❖ **Option 1: Change The Default Plan To Plan 2 For PERS, TRS And SERS.**

- Maintains consistency between the plans.
- Ensures members are not defaulted into plan with more investment risk.
- Doesn't address possible legal or market-driven policy concerns.

❖ **Option 2: Change The Default Plan To Plan 2 For PERS Only.**

- Eliminates legal concerns related to optional membership for TRS and SERS new employees.
- Ensures members are not defaulted into plan with more investment risk.
- Doesn't address possible concern over decision being market-driven.

## Committee Activity

Staff briefed the Committee on this issue in November. The Committee held a public hearing and took executive action in December. The Committee moved to recommend Option 2 to the Legislature.

## Recommendation To 2009 Legislature

Change the default retirement plan from Plan 3 to Plan 2 for new members of PERS who do not select a plan upon hire.

## Staff Contact

Dave Nelsen, Senior Policy Analyst  
360.786.6144  
nelsen.dave@leg.wa.gov

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## In Brief

### ISSUE

*New employees hired into PERS, TRS, or SERS eligible positions must choose to be a member of Plan 2 or Plan 3. Members who don't choose are "defaulted" into membership in Plan 3. Stakeholders have suggested that members who don't choose should be defaulted into Plan 2.*

### MEMBER IMPACT

*This change would impact all new hires into PERS, TRS, and SERS eligible positions. Since the inception of optional membership, beginning for PERS in March 2002, over 95,000 new employees have been faced with the Plan 2 or Plan 3 choice. Of these, nearly 18,000 have been defaulted into Plan 3. See Appendix A for more information.*

Dave Nelsen  
Senior Policy Analyst  
(360) 786-6144  
nelsen.dave@leg.wa.gov

# Change Membership Default for Plans 2/3

## Introduction

The SCPP is being asked to change the optional plan choice default provisions in the Plans 2/3 of the Public Employees' Retirement System (PERS), the Teachers' Retirement System (TRS), and the School Employees' Retirement System (SERS). The requested change would require new employees who failed to choose Plan 2 or Plan 3 to become permanent members of Plan 2 by default. Currently, new employees who fail to choose a plan are permanently defaulted into membership in Plan 3. This request raises two immediate policy questions:

- ❖ Should the plan default be changed, particularly at this time?
- ❖ If so, how should the default be determined?

## Current Situation

New employees hired into eligible positions in PERS, TRS, and SERS have ninety days from their first day of employment to choose whether to become members of Plan 2 or Plan 3. New employees who do not decide within the ninety-day window become members of Plan 3 by default. Whether members choose or are defaulted into a plan, their plan designation cannot change; the decision or designation is irrevocable.

## History

TRS Plan 3, implemented in 1995, was the first Plan 3 in Washington State. At the time, all new teachers were required to be members of Plan 3. This was also true for SERS Plan 3, implemented in 2000. Classified employees hired after 2000 were also required to become members of SERS Plan 3.

The choice of Plan 3 as the default plan began with the implementation of PERS Plan 3 in March 2002. When PERS Plan 3 was created, the Legislature gave new public

*Using Plan 3 as the default plan started with PERS in 2002 and was later expanded to TRS and SERS in 2007.*

employees the irrevocable choice upon hiring to become a member of Plan 2 or Plan 3. If a new employee failed to make a choice, they were defaulted into PERS Plan 3.

In 2007, the Legislature continued to use Plan 3 as the default plan when they implemented optional membership in TRS and SERS. These benefits, and others, were passed in HB 2391, which also repealed the provisions of gain-sharing. Some of the provisions of this bill are currently being litigated.

### **Comparing Plan 2 And Plan 3**

Plan 2 and Plan 3 provide different designs to accrue a retirement benefit. Understanding the differences in the design of the two plans may help policy makers understand the potential impact of changing the default plan to future new employees.

Below is a description of the benefit design provided by each plan.

*Plan 2 is a defined benefit plan that provides a monthly payment for life based upon a formula.*

**Plan 2** is a **defined benefit retirement plan** that provides a monthly payment for life based upon a formula. The benefit is defined because the formula is known. The Plan 2 benefit formula is: 2% X years of service X salary average. The Plan 2 benefit is funded by equal employee and employer contributions, which may vary over time depending upon the funding needs of the plan. The full benefit is guaranteed by the state of Washington, so employees do not carry the investment risk for their benefits, the state does.

### **Some Benefits Of Plan 2**

*Plan 2 offers a cost effective method to provide replacement income at retirement.*

For a new employee who will remain a member until retirement, DB plans, like the Plans 2, are generally a very cost effective method to provide lifetime retirement income\*.

First, because they "pool" all members into a common fund, defined benefit plans only have to collect enough contributions and earnings to fund the "average" lifetime of the member. Members who fund their own retirement would have to contribute and earn more in order to ensure they wouldn't outlive their savings if they lived longer than the average.

Second, because large defined benefit plans invest over a very long time horizon, they can afford to take on more investment risk, which should lead to higher returns. Individual members are often advised to change their investment allocations to less risky products as they near and enter retirement, which leads to lower lifetime investment returns.

Finally, defined benefit plans generally achieve higher investment returns than individual investors. Defined benefit plans use investment professionals, have access to investment asset classes that individuals typically don't, and can use their size to negotiate lower investment fees. Over a long career, a small increase in investment returns can provide a significantly higher benefit.

\* Beth Almeida and William Forna, "A Better Bang for the Buck," *National Institute on Retirement Security*, <<http://www.nirsonline.org/index.php>>, August 2008, <[http://www.nirsonline.org/storage/nirs/documents/ky\\_dc\\_working\\_group.pdf](http://www.nirsonline.org/storage/nirs/documents/ky_dc_working_group.pdf)>, accessed August 2008.

*Plan 2 offers members a lower risk retirement plan that requires little involvement in managing the benefit.*

Plan 2 is also of value to members who don't want to assume the primary responsibility and risk for their own retirement funding. In a defined benefit plan, the plan sponsor assumes the responsibility and the risk to invest and provide a retirement benefit for the employees. This provides the member with a secure, known benefit that is guaranteed. For members who lack the investment confidence, the desire to more directly manage their retirement income, or the time to accrue substantial earnings, this option can be desirable. However, members do still bear the responsibility to determine if the amount provided by the plan is sufficient for their own retirement needs, and make additional plans if it is not.

**Plan 3** is a **hybrid retirement plan**, because it contains two separate components:

- ❖ A defined contribution account.
- ❖ A defined benefit account.

The *defined contribution* account is funded by the member's own contributions. The plan gives members the choice of how much they want to contribute to their own retirement, and options to manage investing those contributions over time. Currently, Plan 3 members have six contribution rate options, beginning at 5 percent, and over nine separate investment funds from which to choose.

New employees, who become members of Plan 3 by default, are also defaulted into a contribution rate of 5 percent and into an investment option that provides the same mix of investments and rate of return as the retirement trust funds managed by the Washington State Investment Board (WSIB).

*Plan 3 has both a defined contribution and defined benefit component.*

This is called a "defined contribution" account because the benefit received by members from the account is not defined, only the amount of contributions into the account is defined. The benefit received from the account is based upon how much members contribute and the associated investment earnings. There is no guaranteed return on the contributions, so members carry the full investment risk. This type of retirement option is very similar to the "401K" retirement plans commonly offered by private employers.

The *defined benefit* account in Plan 3 is paid by the employer contributions. The defined benefit provided is similar to the Plan 2 defined benefit, a lifetime monthly payment based upon a formula, guaranteed by the state. However, because member contributions are not funding the defined benefit in Plan 3 like they are in Plan 2, the value is half that of the Plan 2 benefit. The Plan 3 defined benefit formula is: 1% X years of service X salary average.

### **Some Benefits Of Plan 3**

Many new employees will never draw a lifetime monthly payment from their retirement plan. It is estimated that less than half of all new PERS employees will remain employed for the five years necessary to earn a guaranteed benefit at age 65\*. Also, some new employees may work long enough to earn a benefit, but will leave public employment prior to age 65. The Plans 3 were designed in recognition of this new, more mobile workforce. The policy statement in the legislation that created TRS Plan 3 stated "...public employees need the ability to make transitions to other private or public sector careers, and ... the retirement system should not be a barrier...."

*Plan 3 offers members more value if leaving the workforce before retiring.*

To accommodate this recognition of greater mobility, Plan 3 provides more opportunity to receive value for both member and employer contributions should employees leave employment prior to retirement. In Plan 2, members who leave employment can withdraw the contributions

made to the plan and any interest that has been credited to their account. However, if they do so, they forfeit all right to a future defined benefit from the system. This means Plan 2 members who withdraw never receive any benefit from all the contributions made by the employer.

In Plan 3, the benefit is split into the defined contribution and the defined benefit accounts. Plan 3 members who leave prior to retirement can withdraw their contributions from the defined contribution account, and it does not impact their eligibility for an employer-funded defined benefit payment in the future. If Plan 3 members earn a guaranteed future payment, they retain the value from the employer contributions.

\* Office of the State Actuary, *2007 Actuarial Valuation Report*, September 2008.

*Plan 3 gives members greater flexibility and control within their retirement plan.*

Plan 3 also offers members more control over their retirement planning. With the increased awareness of the stock market in the late 1980s and early 1990s, many employees wanted flexibility and control over their retirement contributions. Plan 3 provides flexibility in the amount of contributions and control over how they are invested. Plan 2 does not provide these benefits. Even if the new employees do not choose Plan 3 initially, this flexibility and control may be desired later in their career.

However, with this increased flexibility and control comes increased risk. Members in Plan 3 are assuming more risk for their future retirement benefit than Plan 2 members. Part of the benefit from Plan 3 comes from the members own contributions and earnings, on which there is no guaranteed return. Therefore, depending upon the amount invested and the earnings, members may or may not have as much income replacement at retirement as Plan 2 members may have.

*Plan 3 shifts some risk of providing a retirement benefit to members, but provides features to help mitigate that risk.*

Some policy makers may question whether a plan designed for active management that shifts some retirement risk to members is appropriate for new employees who cannot choose a retirement plan in ninety days. While there is more risk to members in this plan, there are several design options within Plan 3 that attempt to mitigate some of that risk.

First, as stated earlier, members who are defaulted into Plan 3 are also defaulted into the WSIB investment option. This provides them with access to a professionally

managed, low-fee, and diverse investment portfolio, the same portfolio that funds the defined benefit plans in Washington. This option mitigates some of the risk for individual investors.

Second, the Plans 3 provide an option for members to purchase a lifetime monthly annuity with their contributions at the time of retirement, paid out of the state retirement funds. Because this annuity is purchased from the state, it provides more benefit for less cost than what could typically be purchased in the private sector, and removes some of the risk of members outliving the value of their investments.

Finally, members still receive a defined benefit payment funded from the employer contributions. This ensures there is some level of secure monthly income being earned.

## Policy Analysis

The request to change the plan membership default in the Plans 2/3 raises two immediate policy questions:

- ❖ Should the default be changed, particularly at this time?
- ❖ If so, how should the default be determined?

### **Should The Plan Default Be Changed?**

As discussed earlier in this paper, Plan 3 was the original choice as the default plan for PERS, and has remained the default choice as optional membership was expanded to TRS and SERS. As shown in **Appendix A**, nearly 18,000 members have been defaulted into Plan 3 since the creation of optional membership. This amounts to approximately 19 percent of all new employees.

The question for policy makers is: Have the values changed that made the Plan 3 design the policy preference for the default plan?

The Plan 3 design offers value for the mobility and flexible retirement planning needs of many new employees. For employers, it offers a retirement plan that helps recruit from the private sector, which primarily offers defined

*Have the values changed that made the Plan 3 design the policy preference for the default plan?*

contribution retirement plans for employees. For the state of Washington, as the plan sponsor, the Plan 3 design shifts some of the investment risk for providing a benefit to members, and lowers the long-term cost of the plan that the state guarantees. As explained earlier, the Plan 3 members carry the investment risk for their own contributions, and the state guarantees the value of the defined benefits paid by employer contributions. Since the Plan 3 defined benefit is half the value of the Plan 2 defined benefit, the state accrues less liability with Plan 3. Shifting the investment risk and lowering the long-term liability were key benefits to the state of implementing Plan 3 and designating Plan 3 as the default plan.

Have the values in the Plan 3 design changed? Do policy makers no longer consider lowering the long-term liability for the state a goal? If the values discussed above have not changed, then some reason must override the design values in significance to consider changing the current plan default. Otherwise, retaining Plan 3 as the default plan would be the consistent approach.

### **Should The Default Be Changed At This Time?**

In addition to the question of whether the Plan 3 default should be changed at all, there are also two concerns raised by the timing of this request. First, as mentioned earlier, the Legislature continued the use of Plan 3 as the default plan when they implemented plan choice for TRS and SERS in HB 2391. Some of the benefit provisions in this bill are in current litigation, and the provisions of plan choice may be impacted by the outcome of this litigation. As a result, the committee may want to consult with their Assistant Attorney General before making a decision on this proposal.

Second, policy makers may want to consider whether the desire to change Plan 3 as the default may be linked to current market conditions. As discussed earlier, in Plan 3 members invest their contributions. When the financial markets are in a downturn, as they are now, the reaction to this financial climate may be that this exposure to investment risk is too great for members to accommodate. Therefore, some feel Plan 2 should be the default plan because the benefit is guaranteed and the state, as plan sponsor, should carry the investment risk, not members. This

*Changing the plan default at this time may raise legal concerns.*

*Policy makers may want to consider whether the desire to change the default from Plan 3 may be linked to current market conditions.*

reaction may not fully consider the cyclical nature of the financial markets. The markets have had periods of tremendous gain, as well as loss. Volatility is part of their nature. When the financial markets are earning significant returns, will there be another request to change the default back to Plan 3 so members can participate in the gains?

### **How Should The Plan Default Be Determined?**

If policy makers no longer feel Plan 3 should be the default plan for new employees from a broad-based policy perspective, then how should they choose which plan should be the default? Two possible approaches are:

- ❖ Use historical plan choice data to set the default.
- ❖ Determine which plan best serves the needs of new employees.

### **Using Historical Data To Set Plan Default**

Appendix A provides detail of new employee choice in the Plans 2/3. PERS has had optional membership since March of 2002, so there is more historical data available. In PERS, over 64 percent of new employees choose Plan 2. An additional 17 percent choose Plan 2, and the remaining 19 percent are defaulted into Plan 3. This data indicates a strong preference in PERS for Plan 2.

*Historical data shows a strong preference for Plan 2 among PERS employees, but the data is somewhat less clear for school employees and*

SERS data also indicates a preference for Plan 2 of 48 percent to 32 percent choosing Plan 3. The remaining 20 percent are defaulted into Plan 3. TRS new members have a slight preference for Plan 3 of 46 to 40 percent choosing Plan 2. The remaining 14 percent of new teachers are defaulted to Plan 3.

While this data does show a strong preference for Plan 2 among PERS employees, the data is somewhat less clear for school employees and teachers. Also, since optional membership for SERS and TRS was implemented only 16 months ago, there is far less data in those plans from which to base a decision. If taking the approach to use historical data to determine the plan default choice, policy makers may want to consider whether enough data is available in SERS and TRS to make an informed choice.

### **Which Plan Best Serves The New Employees?**

Policy makers may also set the plan default based upon a judgment of which plan best serves the new employees. This determination is complicated; however, as Plan 2 and Plan 3 were each designed to best serve the needs of different members. As discussed earlier in this paper when comparing the benefits in the two plans, Plan 2 may provide more value to the new employees who stay and retire from the system, or who don't want the primary responsibility or the risk of managing their own retirement. Plan 3 may be preferable for the new employees who will likely leave public employment prior to retirement, or those who may remain, but want more flexibility and options than a typical defined benefit plan provides.

Policy makers would need to determine which group of new members they would like to best serve. Those new employees who will stay to retirement age may be benefited by a Plan 2 default, and those who leave prior to retiring may be benefited by a Plan 3 default.

### **Should There Be Different Defaults For Different Members?**

*Instead of one default for all retirement systems, other approaches could include defaults based upon each system's demographics, or plan default based upon groupings of new employees.*

Applying one default plan for all the Plans 2/3 would necessarily mean some members are defaulted into a plan that may not be best suited for their needs. A different approach may be to fit the default to the demographics of new employees in the retirement system. For example, PERS and SERS new employees are far more likely to leave the workforce prior to the normal age of retirement than new TRS employees. Would a Plan 3 default suit these employees better since it may provide more value to a departing worker? If new employees in TRS are more likely to work to the normal age of retirement, should they be given a Plan 2 default since Plan 2 is a cost effective means of providing retirement income? This approach could result in different default plans among the three retirement systems.

Another approach would be to fit the default to groupings of new employees specifically. For example, Plan 3 may be more valuable to younger employees who have time to invest and manage their contributions through market volatility. Plan 3 may be a logical choice as the default for these new employees. But what of new employees that

enter the workforce at later ages? They may not have time to earn significant investment gains in Plan 3. New employees past a certain age may benefit from being defaulted into Plan 2. This approach could result in different plan defaults within each retirement system.

### **Other States**

Among the comparative states, only two systems offer new employees a choice between a defined benefit plan and some form of defined contribution or hybrid plan, Ohio PERS and the Florida Retirement System.

*Only two comparative systems offer similar plan choice to new employees, and both systems default members into the defined benefit option.*

Ohio PERS gives new employees a choice between a traditional defined benefit plan like Plan 2, a hybrid retirement plan like Plan 3, and a defined contribution plan. If members do not choose a plan, they are defaulted into the traditional defined benefit plan.

The Florida Retirement System gives new members the option to participate in a defined benefit plan and a defined contribution plan. Like Ohio PERS, if members fail to make a timely choice, they are defaulted into the defined benefit plan.

### **Conclusion**

There is a request to the SCPP to change the plan choice default in the Plans 2/3. Plan 3 has been the policy choice as the plan default since the inception of optional membership in 2002, and remained the default choice when optional membership was expanded in 2007. Have the plan design values that drove that default policy changed?

Is now the right time to change the plan default? There are also timing considerations concerning changing the plan default. These include possible legal concerns and the impact of the current financial markets on the desire for change.

If policy makers don't have a policy preference for continuing the use of Plan 3 as the default, how should they determine which plan should be the default?

- ❖ Look at historical data of plan choice preference?

- ❖ Make a determination of which plan best serves the needs of new employees?

A look at similar situations in comparative state systems shows that only two systems offer new employees a similar plan choice as Washington. In both of those systems, members who fail to choose within their allotted time period are defaulted into a defined benefit plan.

## Committee Activity

Staff briefed the Committee on this issue in November. The Committee held a public hearing and took executive action in December. The Committee moved to recommend to the Legislature a change to the default for PERS only.

## Executive Committee Recommendation

Change the default retirement plan from Plan 3 to Plan 2 for new members of PERS, TRS and SERS who do not select a plan upon hire. Recommended November 18, 2008.

## Recommendation To 2009 Legislature

Change the default retirement plan from Plan 3 to Plan 2 for new members of PERS who do not select a plan upon hire. Recommended December 16, 2008.

## Bill Draft

A Code Reviser bill draft to implement the SCPP recommendation is attached (Z-0395.1/09).

## Draft Fiscal Note

Attached.

## Appendix A

### **PERS Choice Data – March 2002 through October 2008**

New Members	85,106	
New Members Opting Into Plan 2	54,067	64%
New Members Opting Into Plan 3	14,882	17%
New Members Defaulting Into Plan 3	16,157	19%

### **TRS Choice Data – July 2007 through October 2008**

New Members	5,189	
New Members Opting Into Plan 2	2,072	40%
New Members Opting Into Plan 3	2,387	46%
New Members Defaulting Into Plan 3	730	14%

### **SERS Choice Data – July 2007 through October 2008**

New Members	5,094	
New Members Opting Into Plan 2	2,443	48%
New Members Opting Into Plan 3	1,616	32%
New Members Defaulting Into Plan 3	1,035	20%

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HOUSE BILL 1722

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State of Washington

61st Legislature

2009 Regular Session

By Representatives Crouse, Conway, Seaquist, and Simpson; by request of Select Committee on Pension Policy

Read first time 01/28/09. Referred to Committee on Ways & Means.

1 AN ACT Relating to plan membership default provisions in the public  
2 employees' retirement system; and amending RCW 41.40.785.

3 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

4 **Sec. 1.** RCW 41.40.785 and 2000 c 247 s 302 are each amended to  
5 read as follows:

6 (1) All employees who first become employed by an employer in an  
7 eligible position on or after March 1, 2002, for state agencies or  
8 institutes of higher education, or September 1, 2002, for other  
9 employers, shall have a period of ninety days to make an irrevocable  
10 choice to become a member of plan 2 or plan 3. At the end of ninety  
11 days, if the member has not made a choice to become a member of plan 2,  
12 he or she becomes a member of plan 2 or plan 3 as follows:

13 (a) He or she becomes a member of plan 3 if first employed by an  
14 employer in an eligible position on or after March 1, 2002, but prior  
15 to July 1, 2009, for state agencies or institutes of higher education,  
16 or on or after September 1, 2002, but prior to July 1, 2009, for other  
17 employers; or

18 (b) He or she becomes a member of plan 2 if first employed by an  
19 employer in an eligible position on or after July 1, 2009.

1           (2) For administrative efficiency, until a member elects to become  
2 a member of plan 3, or becomes a member of plan 3 by default pursuant  
3 to subsection (1) of this section, the member shall be reported to the  
4 department in plan 2, with member and employer contributions. Upon  
5 becoming a member of plan 3 by election or by default, all service  
6 credit shall be transferred to the member's plan 3 defined benefit, and  
7 all employee accumulated contributions shall be transferred to the  
8 member's plan 3 defined contribution account.

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