Change Plans 2/3 Default

Description of Issue

The SCPP is being asked to change 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). 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. The current default plan is Plan 3.

History

- Plan 3 was the default plan when plan choice was introduced with PERS Plan 3 in 2002.
- The Legislature continued to use Plan 3 as the default when new teachers and school employees were granted plan choice in 2007.

Policy Considerations

- 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?
- There are different implications for eliminating the default than there are for changing the default to Plan 2.
  - May raise questions about whether the benefits are definitely determinable.
  - Participation is mandatory, but it is not possible to force someone to make an affirmative choice.

Committee Activity

The SCPP had a work session on this issue in November. At that meeting, the Executive Committee directed staff to prepare a bill draft for the December meeting to change the default plan to Plan 2 for PERS, SERS, and TRS.

The Executive Committee also directed staff to prepare an option for eliminating the plan default altogether.

Bill Drafts

A bill draft is attached that changes the default plan to Plan 2 for PERS, TRS and SERS.

Next Step

This issue is scheduled for public hearing and possible executive action at the December meeting.

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Change Plans 2/3 Default

This report was updated in November 2009 to reflect new SCPP action, and a section entitled, "Is Eliminating the Default Provision a Viable Option?" was added. Appendix A has been updated with new plan member data. The remainder of the report is substantively unchanged from 2008.

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.

Aaron Gutierrez
Senior Policy Analyst
(360) 786-6152
gutierrez.aaron@leg.wa.gov

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 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.

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

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 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.

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

Some Benefits Of Plan 2

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.

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

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 Fornia, "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>, 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

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

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…."

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.

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

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.

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?

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 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?

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

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.

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

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 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.

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

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 3, and the remaining 19 percent are defaulted into Plan 3. This data indicates a strong preference in PERS for Plan 2.

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 percent 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.

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.

Should There Be Different Defaults For Different Members?

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.

Is Eliminating the Default Provision a Viable Option?

Upon review, eliminating the default and changing the default to Plan 2 requires very different analyses. Eliminating the default would require policy makers to revisit some fundamental principles and aspects of Washington's retirement systems.

In discussing the elimination of the default provision, policy makers may need to consider compliance with federal law and the need for mandatory participation.

Compliance with Federal Law

Federal law does not explicitly bar the state from offering a choice of plans for more than ninety days, but any modification that could extend or eliminate that time period could raise questions of whether the benefits are definitely determinable.

Under federal law,[1] a defined benefit plan, or portion of a plan, must have definitely determinable benefits that are not subject to employer discretion. If an employee were allowed to wait for an extended period of time before being placed (by choice or default) into a plan, that employee's benefits would remain undeterminable for that extended period of time.

[1] *See 26 CFR 1.401-1 and 26 USC §401(a).*

Mandatory Participation

Since the inception of retirement systems in Washington, the Legislature has chosen to require mandatory participation. A default provision serves to ensure this participation since it is difficult, if not impossible, to force someone to make an affirmative choice. Without a default, employees could theoretically wait until the day they retire to affirmatively make a selection.

Default provisions are used in two other programs that require mandatory participation.

New employees must choose a medical and dental plan within 31 days. If they do not make the choice during the allotted time, they are defaulted into the Uniform Medical Plan and Uniform Dental Plan.[2]

At the federal level, new employees must complete and submit an IRS form W-4 to the employer in order for the employer to calculate the employee's withholding. If the employee does not complete and submit a form W-4, the employer must withhold income taxes as though the employee was single, with no withholding allowances.[3]

[2] *WAC 182-08-197*
[3] *See IRS Publication 15, Section 9, p. 16.*

Other States

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

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.

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

The SCPP had a work session on this issue in November 2008. At that meeting, the Executive Committee directed staff to prepare a bill draft and fiscal note for the December 2008 meeting to change the default plan to Plan 2.

The SCPP held an additional work session on this issue at the November 2009 meeting. Staff was directed to draft a bill for the December 2009 meeting establishing a Plan 2 default for PERS, SERS, and TRS.

Staff was also directed to prepare an option for eliminating the default provision altogether.

Bill Drafts

A bill draft is attached that changes the default plan to Plan 2 for PERS, TRS, and SERS.

Draft Fiscal Note Summary

Attached.

Next Steps

This issue is scheduled for public hearing and possible executive action at the December meeting.

Appendix A

Plan 3 Choice Data						
System and Plan	PERS 3		TRS 3		SERS 3	
	Count	Percent of Total	Count	Percent of Total	Count	Percent of Total
New Members	94,128		7,526		8,359	
New Members Opting Into Plan 2	60,040	64%	2,999	40%	4,005	48%
New Members Opting Into Plan 3	16,114	17%	3,106	41%	2,403	29%
New Members Defaulting Into Plan 3	17,974	19%	1,421	19%	1,951	23%

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ACTUARY'S FISCAL NOTE

RESPONDING AGENCY:	CODE:	DATE:	PROPOSAL [NAME or Z-NUMBER]:
Office of the State Actuary	**035**	**12/02/09**	**Plan 2/3 Default**

WHAT THE READER SHOULD KNOW

The Office of the State Actuary ("we") prepared this draft fiscal note based on our understanding of the proposal as of the date shown above. We intend this draft fiscal note to be used by the Select Committee on Pension Policy during the 2009 Interim only.

We advise readers of this draft fiscal note to seek professional guidance as to its content and interpretation, and not to rely upon this communication without such guidance. Please read the analysis shown in this fiscal note as a whole. Distribution of, or reliance on, only parts of this draft fiscal note could result in its misuse and may mislead others.

SUMMARY OF RESULTS

This proposal changes the Plan 2/3 membership plan default in the Public Employees' Retirement System (PERS), the Teachers' Retirement System (TRS), and the School Employees' Retirement System (SERS), from Plan 3 to Plan 2. This proposal doesn't increase the benefits or liabilities of the current Plans 2/3 members from these systems, but would change future contribution levels due to assumed changes in future plan membership.

Impact on Pension Liability			
(Dollars in Millions)	**Current**	**Increase**	**Total**
Today's Value of All Future Pensions	$70,619	$0.0	$70,619
Earned Pensions Not Covered by Today's Assets	$5,411	$0.0	$5,411

Impact on Contribution Rates: (Effective 09/01/2010)			
2010-2011 State Budget	**PERS**	**TRS**	**SERS**
Employee (Plan 2)	0.00%	0.00%	0.00%
Employer:			
Current Annual Cost	0.00%	0.00%	0.00%
Plan 1 Past Cost	0.00%	0.00%	0.00%
Total	0.00%	0.00%	0.00%

Budget Impacts			
(Dollars in Millions)	**2010-2011**	**2011-2013**	**25-Year**
General Fund-State	$0.0	$0.1	$0.3
Total Employer	$0.0	$0.2	($8.2)

See the Actuarial Results section of this draft fiscal note for additional detail.

WHAT IS THE PROPOSED CHANGE?

Summary Of Change

This proposal impacts the following systems:

- PERS Plans 2/3
- TRS Plans 2/3
- SERS Plans 2/3

This proposal impacts the Plans 2 and 3 of these systems. This proposal would change the current plan membership default from Plan 3 to Plan 2. New employees who first become employed by an employer in eligible positions after July 1, 2010, would have 90 days to choose membership in Plan 2 or Plan 3. If the new employee does not make a choice within 90 days, they become a member of Plan 2.

For administrative ease employers report all new employees in Plan 2 until they choose membership in Plan 3. At that point the Department of Retirement Systems (DRS) transfers the member's service credit to their Plan 3 defined benefit accounts and the member's Plan 2 contributions to their Plan 3 defined contribution accounts.

Effective Date: 90 days after session.

What Is The Current Situation?

New employees who first become employed by an employer in PERS, TRS, and SERS eligible positions have 90 days to choose membership in Plan 2 or Plan 3. If the new employee does not make a choice within 90 days, they become a member of Plan 3, contribute at the minimum contribution rate (5 percent), and the Washington State Investment Board invests their contributions.

For administrative ease employers report all new employees in Plan 2 until they choose to join or default into Plan 3. At that point DRS transfers the member's service credit to their Plan 3 defined benefit accounts and the member's Plan 2 contributions to their Plan 3 defined contribution accounts.

Who Is Impacted And How?

This bill will impact all future members of PERS, TRS, and SERS who don't choose a pension plan. This bill does not impact the benefits of the current members of these systems.

This bill potentially impacts all current PERS, TRS, and SERS Plan 2 active members through decreased contribution rates. Additionally, this bill will not affect member contribution rates in Plan 3 since Plan 3 members do not contribute to their employer-provided defined benefit.

See the Special Data Needed section of this fiscal note for more details.

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WHY THIS PROPOSAL HAS A COST AND WHO PAYS FOR IT

Why This Proposal Has A Cost

We assume this proposal will increase the percentage of new entrants that go into Plan 2 in the future. On average, we expect members of Plan 2 to work longer and retire later than members of Plan 3 because Plan 2 has a more strict early retirement eligibility standard. Plan 3 members are eligible to retire at age 55 after ten years of service; whereas, Plan 2 members are eligible to retire at age 55 after twenty years of service.

When we assume more members join Plan 2 in the future, costs in the affected systems change in two areas:

- System contribution rates decrease slightly since the longer assumed working careers in Plan 2 means the system will have more future salary to fund future benefits. Since the employer provided benefits in Plan 2 and Plan 3 are very similar, increasing the assumed salary available to fund those benefits decreases the contribution rates.
- Projected contributions on existing system benefits (before the proposed changes under this bill) will increase since the affected systems will levy contributions rates on a larger projected future salary base due to longer expected working careers of Plan 2 members.

The expected change in projected contributions on existing system benefits due to larger projected future salary offsets the savings of this bill from slightly lower contribution rates. The amount of this offset varies by affected retirement system. Please see the Actuarial Results Section for more detail.

Who Will Pay For These Costs?

To the extent that the combined cost of PERS, TRS, and SERS change because of this proposal, the employers and active Plan 2 members will fund those changes using the same funding method as the other costs of the plan. Employers will pay the defined benefit costs for Plan 3 members and half the cost for Plan 2 members. Plan 2 members pay for the other half of their costs.

HOW WE VALUED THESE COSTS

Assumptions We Made

We assumed the portion of new entrants going into Plan 2 would increase for PERS, TRS, and SERS from two-thirds to three-quarters. We also assumed future new entrants would have the same demographic characteristics (or profile) as the combined Plan 2/3 new entrants in the 2008 valuation data. Therefore, we did not assume different new entrant profiles by plan as we did in our prior fiscal note for this proposal and in our projection system. With this assumption change, differences in plan design influence the cost more so than assumed changes in future new entrant profiles by plan.

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For more detail please see Appendix A.

How We Applied These Assumptions

We used our liability projection system to project the current group of active members into the future. First we updated our existing projections to reflect a combined Plan 2/3 new entrant profile instead of plan specific profiles. This established a new base run for this pricing exercise. Then using the new entrant assumptions described above (an increase in members selecting Plan 2 in the future) in combination with the 1.25 percent membership growth assumption in PERS and SERS, and 0.90 percent in TRS, we replaced the current active members as they left active service, and allowed the active populations to increase each year. We compared the results of this new projection to our new base-run projections to isolate future contribution rate differences and changes in future system salary due to this proposal.

Special Data Needed

DRS provided us with new entrant data for PERS, TRS, and SERS. Data for these systems included new entrants starting in: March of 2002 for PERS, and July of 2007 for TRS and SERS; through September of 2009. The data by system included – the:

- Total number of new entrants into the system.
- Number of members opting into Plan 2.
- Number of members opting into Plan 3.
- Number of members defaulting into Plan 3.

Otherwise, we developed these costs using the same assets and data as disclosed in the June 30, 2008, Actuarial Valuation Report (AVR).

For more detail please see Appendix B.

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ACTUARIAL RESULTS

How The Liabilities Changed

This proposal does not impact the liabilities for the current active members of PERS, TRS, and SERS since it does not change the benefits of any plan.

How Contribution Rates Changed

This proposal does not impact the contribution rates for the current active members of PERS, TRS, and SERS in the 2009-11 Biennium. But this proposal does change contribution rates for the Plans 2/3 of these systems in future biennia due to changes in future plan membership. We used these rate changes to measure the budget changes in future biennia.

How This Impacts Budgets

Because this proposal changes both future contribution rates and the assumed value of future salaries available to make contributions, we decided to split the budget impact into the two main components of the cost: (1) change in contribution rates, and (2) change in expected future salaries.

The results of our projections indicate that all three systems would experience a slight decrease in contribution rates in future biennia. The impact of this component alone will decrease future system cost. The following table shows the projected budget impact of this change. We do not expect any impact in the first two biennia from this change.

Budget Impacts – From Change in Contribution Rates				
(Dollars in Millions)	**PERS**	**TRS**	**SERS**	**Total**
2013-2035				
General Fund	($2.7)	($1.8)	($0.7)	($5.2)
Non-General Fund	(3.9)	0.0	0.0	(3.9)
Total State	**($6.6)**	**($1.8)**	**($0.7)**	**($9.0)**
Local Government	(7.0)	(0.9)	(0.8)	(8.7)
Total Employer	**($13.6)**	**($2.7)**	**($1.5)**	**($17.8)**

Note: Totals may not agree due to rounding.

On the other hand, we also expect an increase in expected future salary for all three systems. The impact of this component alone will increase future system cost. The following table shows the projected budget impact of this change. We do not expect any impact in the current biennium from this change.

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Budget Impacts – From Change in Expected Future Salary				
(Dollars in Millions)	**PERS**	**TRS**	**SERS**	**Total**
2011-2013				
General Fund	$0.0	$0.1	$0.0	$0.1
Non-General Fund	0.0	0.0	0.0	0.0
Total State	**$0.1**	**$0.1**	**$0.0**	**$0.1**
Local Government	0.1	0.0	0.0	0.1
Total Employer	**$0.1**	**$0.1**	**$0.0**	**$0.2**
2010-2035				
General Fund	$0.4	$4.9	$0.1	$5.4
Non-General Fund	0.5	0.0	0.0	0.5
Total State	**$0.9**	**$4.9**	**$0.1**	**$5.9**
Local Government	0.9	2.5	0.1	3.6
Total Employer	**$1.8**	**$7.5**	**$0.3**	**$9.5**

Note: Totals may not agree due to rounding.

The total budget impact for each system is the sum of these two prior tables. Notice that the increase in expected future salary for TRS has a greater impact than the decrease in contribution rates. That is not the case with PERS and SERS. Therefore, that is why we expect an overall cost for TRS and an overall savings for PERS and SERS. The following table shows the combined impact of these two components.

Budget Impacts - Total				
(Dollars in Millions)	**PERS**	**TRS**	**SERS**	**Total**
2010-2011				
General Fund	$0.0	$0.0	$0.0	$0.0
Non-General Fund	0.0	0.0	0.0	0.0
Total State	**$0.0**	**$0.0**	**$0.0**	**$0.0**
Local Government	0.0	0.0	0.0	0.0
Total Employer	**$0.0**	**$0.0**	**$0.0**	**$0.0**
2011-2013				
General Fund	$0.0	$0.1	$0.0	$0.1
Non-General Fund	0.0	0.0	0.0	0.0
Total State	**$0.1**	**$0.1**	**$0.0**	**$0.1**
Local Government	0.1	0.0	0.0	0.1
Total Employer	**$0.1**	**$0.1**	**$0.0**	**$0.2**
2010-2035				
General Fund	($2.3)	$3.2	($0.5)	$0.3
Non-General Fund	(3.3)	0.0	0.0	(3.3)
Total State	**($5.7)**	**$3.2**	**($0.5)**	**($3.1)**
Local Government	(6.1)	1.6	(0.7)	(5.1)
Total Employer	**($11.7)**	**$4.8**	**($1.2)**	**($8.2)**

Note: Totals may not agree due to rounding.

Note that we did not provide the budget impact on employees since most of the budget change for employees is due to the plan into which members default and not due to the cost of this bill. More specifically, defaulting members will pay the Plan 2 calculated

member rate in future biennia, compared to the fixed 5 percent of salary that these members would have contributed had they defaulted into Plan 3.

The analysis of this bill does not consider any other proposed changes to the system. The combined effect of several changes to the systems could exceed the sum of each proposed change considered individually.

As with the costs developed in the actuarial valuation, the emerging costs of the systems will vary from those presented in the AVR or this fiscal note to the extent that actual experience differs from the actuarial assumptions.

HOW THE RESULTS CHANGE WHEN THE ASSUMPTIONS CHANGE

To determine the sensitivity of the actuarial results to the best-estimate assumptions selected for this pricing we varied the following assumptions:

The proportion of new entrants becoming Plan 2 members by default. We looked at the 25-year budget impacts of assuming the following percentages of new entrants becoming Plan 2 members:

- 70 percent.
- 80 percent.

25-Year Budget Impacts	
(Dollars in Millions)	**Total**
70% of New Entrants into Plan 2	
General Fund	$0.9
Non-General Fund	(2.0)
Total State	**($1.1)**
Local Government	(2.7)
Total Employer	**($3.8)**
75% of New Entrants into Plan 2 (Best Estimate)	
General Fund	$0.3
Non-General Fund	(3.3)
Total State	**($3.1)**
Local Government	(5.1)
Total Employer	**($8.2)**
80% of New Entrants into Plan 2	
General Fund	($3.0)
Non-General Fund	(3.7)
Total State	**($6.7)**
Local Government	(7.6)
Total Employer	**($14.4)**

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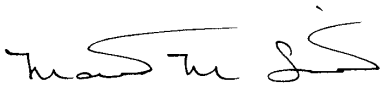
ACTUARY'S CERTIFICATION

The undersigned hereby certifies that:

1. The actuarial cost methods are appropriate for the purposes of this pricing exercise.
2. The actuarial assumptions used are appropriate for the purposes of this pricing exercise.
3. The data on which this draft fiscal note is based are sufficient and reliable for the purposes of this pricing exercise.
4. Use of another set of methods, assumptions, and data may also be reasonable, and might produce different results.
5. We prepared this draft fiscal note for the Select Committee on Pension Policy.
6. We prepared this draft fiscal note and provided opinions in accordance with Washington State law and accepted actuarial standards of practice as of the date shown on page 1 of this draft fiscal note.

While this draft fiscal note is meant to be complete, the undersigned is available to provide extra advice and explanations as needed.



Matthew M. Smith, FCA, EA, MAAA
State Actuary

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APPENDIX A – ASSUMPTIONS WE MADE

In general we assume that two-thirds of all future entrants into PERS, TRS, and SERS will choose to join Plan 2, and that the remaining one-third will enter Plan 3. The data provided by DRS, shown in Appendix B, shows the portion of new entrants who defaulted into Plan 3. We converted the proportions shown into values corresponding to our one-third/two-thirds assumption in the following manner for each system. The example below shows the calculations for PERS:

(1) Portion of new entrants we assume enters Plan 3 = 33 percent.
(2) Portion of new entrants who actually entered Plan 3 = 36 percent.
(3) Portion of new entrants who actually entered Plan 3 by default = 19 percent.
(4) Portion of (1) we assumed entered Plan 3 by default = (1) * (3) / (2) = 18 percent.
(5) Portion of members who defaulted into Plan 3 who we assumed did not specifically want to be in Plan 3 = 67 percent.
(6) Portion of (4) we assume would default into Plan 2 under this bill = (4) * (5) = 12 percent.
(7) Portion of new entrants we assume enters Plan 3 under this bill = (1) – (6) = 22 percent.

The above process led to 22 percent of new entrants becoming PERS 3 members. We assumed 75 percent of new entrants would enter Plan 2 and 25 percent would enter Plan 3. Please note that we rounded the intermediate results for display purposes, but used the unrounded results in all calculations above.

Otherwise, we developed these costs using the same assumptions as disclosed in the AVR.

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APPENDIX B – SPECIAL DATA NEEDED

DRS provided the following data:

Department of Retirement Systems - Plan 3 Choice Data

Data provided starting March of 2002 for PERS, and July of 2007 for TRS and SERS; and ending September of 2009.

Plan 3 Choice Data						
System and Plan	PERS 3		TRS 3		SERS 3	
	Count	Percent of Total	Count	Percent of Total	Count	Percent of Total
New Members	94,128		7,526		8,359	
New Members Opting Into Plan 2	60,040	64%	2,999	40%	4,005	48%
New Members Opting Into Plan 3	16,114	17%	3,106	41%	2,403	29%
New Members Defaulting Into Plan 3	17,974	19%	1,421	19%	1,951	23%

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GLOSSARY OF ACTUARIAL TERMS

Actuarial Accrued Liability: Computed differently under different funding methods, the actuarial accrued liability generally represents the portion of the present value of fully projected benefits attributable to service credit that has been earned (or accrued) as of the valuation date.

Actuarial Present Value: The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of actuarial assumptions (i.e. interest rate, rate of salary increases, mortality, etc.).

Aggregate Funding Method: The Aggregate Funding Method is a standard actuarial funding method. The annual cost of benefits under the Aggregate Method is equal to the normal cost. The method does not produce an unfunded liability. The normal cost is determined for the entire group rather than on an individual basis.

Entry Age Normal Cost Method (EANC): The EANC method is a standard actuarial funding method. The annual cost of benefits under EANC is comprised of two components:

- Normal cost.
- Amortization of the unfunded liability.

The normal cost is determined on an individual basis, from a member's age at plan entry, and is designed to be a level percentage of pay throughout a member's career.

Normal Cost: Computed differently under different funding methods, the normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year.

Projected Unit Credit (PUC) Liability: The portion of the Actuarial Present Value of future benefits attributable to service credit that has been earned to date (past service).

Projected Benefits: Pension benefit amounts which are expected to be paid in the future taking into account such items as the effect of advancement in age as well as past and anticipated future compensation and service credits.

Unfunded PUC Liability: The excess, if any, of the Present Value of Benefits calculated under the PUC cost method over the Valuation Assets. This is the portion of all benefits earned to date that are not covered by plan assets.

Unfunded Actuarial Accrued Liability (UAAL): The excess, if any, of the actuarial accrued liability over the actuarial value of assets. In other words, the present value of benefits earned to date that are not covered by plan assets.

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NOTE: This bill draft is substantively identical to the bill draft presented to the SCPP in 2008. Only the effective dates have been changed. Staff is working with the AAG to determine whether any additional technical language is needed because of pending litigation.

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AN ACT Relating to plan membership default provisions in the public employees' retirement system, the teachers' retirement system, and the school employees' retirement system; and amending RCW 41.32.835, 41.35.610, and 41.40.785.

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

Sec. 1. RCW 41.32.835 and 2007 c 491 s 3 are each amended to read as follows:

(1) All teachers who first become employed by an employer in an eligible position on or after July 1, 2007, shall have a period of ninety days to make an irrevocable choice to become a member of plan 2 or plan 3. At the end of ninety days, if the member has not made a choice to become a member of plan 2, he or she becomes a member of plan 3 <u>or plan 2 as follows:</u>

<u>(a) Becomes a member of plan 3 if first employed by an employer in an eligible position on or after July 1, 2007, but prior to July 1, 2010;</u>

(b) Becomes a member of plan 2 if first employed by an employer in an eligible position on or after July 1, 2010.

These plan choice and default provisions are subject to the rights reserved by the legislature in subsection (3) of this section.

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

(3) The plan choice provision as set forth in section 3, chapter 491, Laws of 2007 was intended by the legislature as a replacement benefit for gain-sharing. Until there is legal certainty with respect to the repeal of chapter 41.31A RCW, the right to plan choice under this section is noncontractual, and the legislature reserves the right to amend or repeal this section. Legal certainty includes, but is not limited to, the expiration of any: Applicable limitations on actions; and periods of time for seeking appellate review, up to and including reconsideration by the Washington supreme court and the supreme court of the United States. Until that time, all teachers who first become employed by an employer in an eligible position on or after July 1, 2007, may choose either plan 2 or plan 3 under this section. If the repeal of chapter 41.31A RCW is held to be invalid in a final determination of a court of law, and the court orders reinstatement of gain-sharing or other alternate benefits as a remedy, then all teachers who first become employed by an employer in an eligible position on or after the date of such reinstatement shall be members of plan 3.

Sec. 2. RCW 41.35.610 and 2007 c 491 s 7 are each amended to read as follows:

(1) All classified employees who first become employed by an employer in an eligible position on or after July 1, 2007, shall have a period of ninety days to make an irrevocable choice to become a member of plan 2 or plan 3. At the end of ninety days, if the member has not made a choice to become a member of plan 2, he or she becomes a member of plan 3 or plan 2 as follows:

(a) Becomes a member of plan 3 if first employed by an employer in an eligible position on or after July 1, 2007, but prior to July 1, 2010;

(b) Becomes a member of plan 2 if first employed by an employer in an eligible position on or after July 1, 2010.

These plan choice and default provisions are subject to the rights reserved by the legislature in subsection (3) of this section.

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

(3) The plan choice provision as set forth in section 7, chapter 491, Laws of 2007 was intended by the legislature as a replacement benefit for gain-sharing. Until there is legal certainty with respect to the repeal of chapter 41.31A RCW, the right to plan choice under this section is noncontractual, and the legislature reserves the right to amend or repeal this section. Legal certainty includes, but is not limited to, the expiration of any: Applicable limitations on actions; and periods of time for seeking appellate review, up to and including reconsideration by the Washington supreme court and the supreme court of the United States. Until that time, all classified employees who first become employed by an employer in an eligible position on or after July 1, 2007, may choose either plan 2 or plan 3 under this section. If the repeal of chapter 41.31A RCW is held to be invalid in

a final determination of a court of law, and the court orders reinstatement of gain-sharing or other alternate benefits as a remedy, then all classified employees who first become employed by an employer in an eligible position on or after the date of such reinstatement shall be members of plan 3.

Sec. 3. RCW 41.40.785 and 2000 c 247 s 302 are each amended to read as follows:

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

<u>(a) Becomes a member of plan 3 if first employed by an employer in an eligible position on or after March 1, 2002, but prior to July 1, 2010, for state agencies or institutions of higher education, or on or after September 1, 2002, but prior to July 1, 2010, for other employers;</u>

<u>(b) Becomes a member of plan 2 if first employed by an employer in an eligible position on or after July 1, 2010</u>.

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

--- END ---