Select Committee on Pension Policy

Educational Briefing: Indirect Costs Of Plan Changes

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July 19, 2011

Today's Presentation

- Focus on indirect costs around closing plans
  - What they are
  - What drives them
- Examples specific to WA plans
- Educational session
- No action is required

What Are Indirect Costs?

- Costs to the retirement systems not directly caused by
  - Benefit changes for current members
  - Funding changes
- Can impact contribution rates depending on
  - Timing of changes
  - Future action of decision makers
- “Stealth” costs
  - Not necessarily intuitive
  - Typically take a long time to emerge
  - Usually unintentional

Three Scenarios That Can Create Indirect Costs

- Closing DB plans
- Closing Plan 2
- Investing DB and DC assets in a common fund
  - Comes up when changing preferred plan design

Scenario 1: Closing DB Plans

- Indirect costs driven by actions of investment managers in response to plan "aging"
- Closing a plan starts the plan aging
  - Current members keep getting older
  - No new members to pull the average age down
- Plan ages as membership becomes older and gets closer to retirement
- As members retire, payouts from plan go up and income from contributions goes down

Aging Can Impact Investment Policy

- Less time available to fund benefits and invest assets
- Less time available to recover from down markets
- Greater need to generate cash to pay benefits
- Investment managers will typically respond by
  - Investing in shorter-term securities
  - Moving toward a lower-risk portfolio
- Similar to individual investors de-risking their portfolios as they near retirement

De-Risking A Portfolio Impacts Returns And Costs

- Risk and reward
  - Higher risk = higher expected returns
  - Lower risk = lower expected returns
- A portfolio with less risk will usually have a lower return
- Lower return creates an indirect cost
  - Contributions must increase

Recap Scenario 1

- Closing a DB plan can create indirect costs
- Investment managers will typically de-risk the portfolio as a plan matures
- Lowers the rate of return
- Increases contribution rates
- Questions?

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Scenario 2: Closing Plan 2

- Indirect costs are driven by Plan 2 cost sharing
  - Contribution rates can go up when fewer people share in the plan's costs
- Plan 2 members and employers share the plan cost
- New Plan 2 members share costs with existing Plan 2 members and employers
  - All pay same "base" contribution rate
- Closing Plan 2 to new members means less people to share in the costs
- Impact on contribution rates can vary
  - Depends on timing

Timing Of Plan 2 Closure Impacts Costs

- When future contribution rates are increasing
  - New Plan 2 members share in rising costs
  - Employers and current Plan 2 members see savings
    - Costs are spread further
- When future contribution rates are decreasing
  - New Plan 2 members share in falling costs
  - Employers and current Plan 2 members see cost
    - Savings are spread further
- Closing Plans 2 when rates increasing creates an indirect cost
  - Fewer people sharing rising costs
  - Contribution rates go up
  - Applies when changing the new member default plan

Recap Scenario 2

- Closing Plan 2 can create indirect costs
- Fewer members to spread costs over
- Can make contribution rates go up or down depending on timing
- Questions?

Scenario 3: Investing DB & DC Assets In Common Fund

- Indirect costs are driven by how investment managers respond to the different investment needs of DB and DC assets
- Mixing DB and DC assets occurs if policy makers require DC assets to be invested in same fund as DB assets
- Policy decision can come up when
  - Closing Plans 2/3 and replacing with pure DC Plan
  - Closing Plan 2 and mandating new hires into Plan 3
  - Creating an optional DC plan

WA Invests Pensions In Single Fund

- Pools assets from all the retirement plans
- Invests them in a single portfolio
  - Commingled Trust Fund (CTF)
- Similar to mutual fund
  - Plans buy shares in CTF
  - CTF invests the money
- Mixing DB and DC assets in CTF has implications for investment policy

DB and DC Plans Have Different Investment Needs

- DB plans are designed for a career workforce
  - Assets intended to stay in the plan until retirement
  - Investment manager determines how assets are invested
  - Opportunity for long-term investing
- DC plans are designed for a more mobile workforce
  - Assets intended to follow members if they leave
  - Members can move money between various investment options
  - Need to move assets around and convert them to cash easily
    - Referred to as liquidity
- DC funds not suited for investing in long-term, illiquid assets
  - Implications for investment managers and investment returns

Increasing DC Assets In CTF Can Lower Returns

- Long-term and illiquid asset classes are some of the highest-performing asset classes in CTF
- Includes real estate and private equity
  - Higher risk than stocks and bonds
  - Typically generate higher returns
- Investment managers will likely start moving out of these asset classes as DC funds take up more of the CTF
- Reducing exposure to real estate and private equity will likely lower rate of return for the CTF
- Lower return creates an indirect cost
  - Contribution must increase

Recap Scenario 3

- Mixing DB and DC assets in the CTF can create indirect costs
- Investment managers may move out of real estate and private equity as DC assets take up more of the portfolio
- Reducing allocations to real estate and private equity will likely lower the return of the fund
- Increase contribution rates
- Questions?

Conclusion

- Indirect costs are the hidden costs of certain kinds of plan changes
  - Closing DB plans
  - Investing DB & DC assets in a single fund
- Driven by cost sharing, and how investment managers respond to plan “aging” and liquidity needs
- Impacted by timing and the future actions of decision makers
- Can be triggered by
  - Closing a DB plan
  - Closing a Plan 2
  - Investing DB and DC assets in a single fund