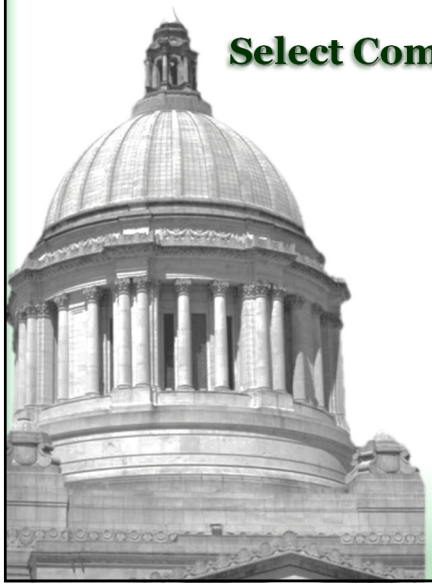

Select Committee on Pension Policy

Educational Session: Plan Design

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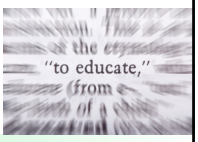
Educational Session

- High-level plan design options
  - Main focus on the "big three" retirement plan designs: DB, DC, Hybrid
  - Also some discussion of supplemental savings plans and bills before Legislature
- No SCPP action



Today's Presentation

- Overview/Initial Considerations
- Framework
  - Step 1 – Identify Goals
  - Step 2 – Identify Risks
  - Step 3 – Evaluate Plan Designs
- Current Structure and Options in Washington
  - DB, Hybrid
  - Supplemental savings vehicles
  - DC plans and pending legislation

Overview: Different Plan Designs For Different Goals

- There is no one-size-fits-all perfect plan design
  - All plans balance pros and cons; benefits and risks
  - Each choice has a trade-off
- Which benefits are most important to you?
- Which risks do you most want to manage?

Initial Considerations

- What are the goals of your retirement plan?
- Who should pay for it?
- Who should own the risks, and how do those risks surface?
- How individualized should it be?
- At what age should employees be retiring?
- Should benefits adjust with demographics or the economy?

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Framework Caveat

- Three main types of retirement plans, but nearly infinite gradations
  - E.g. retirement ages, vesting, cost sharing, etc.
- Not covering sub-options today
  - Can strengthen or undermine the pros and cons of the big three plan designs
  - For example
    - In a DC plan the member generally assumes investment risk
    - But, a DC plan could be designed to shift some risk to employer

Step 1 – Identify Your Most Important Goals

- Sample goals
  - Income replacement
    - To what level?
      - How should this interact with Social Security, health insurance, and other savings?
      - Should it be the same portion for all employees?
    - Should there be a guaranteed minimum?
  - Benefit lifespan
    - Should the benefits continue for life, or have some limit?
    - Survivor benefits?
  - Affordability and value
  - Predictable costs
    - Minimal changes from year to year in employer budgets and employee take-home pay
  - Recruitment and retention

Step 2 – Identify The Risks You Most Want To Manage

- Each plan design reacts to risk differently
- Examples of risks
  - Affordability
    - Investment risk
    - Underfunding
    - Additional unforeseen contributions
    - Contractual rights
  - Benefits
    - May not replace high enough percentage of income
    - Members may outlive their benefits
    - Member may retire in a down market

Step 3 – Evaluate Plan Designs

- Choose the plan that best balances goals and risks
- What are some of the pros/cons of the big three?
  - Theoretical plans – not necessarily Washington's plans
- More importantly, *from whose perspective* is it a pro or con?
  - Each choice is a trade-off
  - A pro for the member may be a con for the employer, and vice versa

Member Perspective: DB Plans

- Predictable level of income replacement
  - Not subject to market conditions or employee investment strategy
- No risk of member outliving benefits
  - However, COLAs, or lack thereof, can impact whether income replacement remains proportionate

Employer Perspective: DB Plans

- "Pay now or pay more later"
  - Can be affordable and cost-effective so long as plan is well-designed and contributions are made
  - If not, costs rise very quickly
- Liability is long-term
  - Current Legislature can encumber future legislatures
  - Closing a plan doesn't remove the liability
- Risk of benefits outliving assets
  - If investment returns low, or contributions insufficient, the plan must bear costs
  - Can weaken intergenerational equity

DB Plans: Recruitment And Retention

- Recruitment
  - Predictable lifetime benefits can help attract some employees
  - But minimal portability may dissuade others
    - If member leaves prior to vesting, generally only receives a return of member contributions
- Retention
  - Encourages long-term employment
  - Can also be perceived as "golden handcuffs"

Possible Ways To Help Manage DB Risks

- One example: risk to affordability and sustainability
- Sound funding methods and assumptions
- Stable and adequate contribution rates
- Consistent, on-time, actuarially-required contributions
- Use extra caution when enacting benefit improvements
  - Especially unfunded and/or retroactive improvements
  - Can weaken intergenerational equity
  - Is it affordable in good times *and* bad?

Member Perspective: DC Plans

- Members can exercise greater control over their retirement
  - Within certain parameters (plans vary on options available)
- Benefit adequacy tied to market performance
  - Possible risks
    - Investments not performing well enough, or retire in a down market
    - Ineffective investment strategy
    - Chosen contribution rate too low to build enough equity
- Member may outlive benefits
  - Drawing from a limited amount of assets

Employer Perspective: DC Plans

- No investment risk
- No risk of benefits outliving assets
- Adding guarantees can introduce DB-style risks
  - Examples
    - Guaranteed minimum benefits
    - Annuity options

DC Plans: Recruitment And Retention

- Recruitment
  - Portability can help attract some employees
    - Members can leave service at any time without sacrificing employer contributions; may have roll-over options
- Retention
  - Less incentive for long-term employment

Possible Ways To Help Manage DC Risks

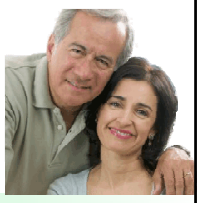
- One example: risk of benefit adequacy for members
- Target date funds, or other investing assistance
  - Target date funds adjust investing strategy based on member's expected retirement date
- Default contribution rates
- Annuity options
  - Ensures long-term benefits
  - Transfers some risk to employer

Hybrid Plans – Pros And Cons Depend On Plan Terms

- Provide some selected balance of defined benefit and defined contribution elements
- Best of both worlds?
  - Can be, but isn't necessarily so
  - Depends on ultimate structure
  - Can take pro and con elements from DB and DC

Quick Recap

- No one-size-fits-all plan
- Plan designs react to risk in different ways
- DB plans
  - Predictable benefits
  - Long-term affordability risk
  - Encourage long-term employment
- DC plans
  - Benefits tied to market
  - No affordability risk
  - Encourage mobile workforce
- Hybrids
  - A compromise between the two designs



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Washington Has DB, Hybrid, Supplemental Savings Plans, And DC Plans

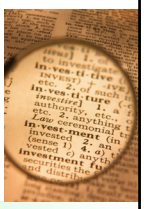
- DB and Hybrid plans available for most employees
- Supplemental savings plans available for many employees
- DC plans available for some higher education employees
- Pending legislation for new DC plans

DB Plans In Washington

- Plans 2 – open and ongoing
- Predictable level of benefits
- Includes equal cost sharing, and other provisions aimed at managing affordability
- Encourages long-term employment

Hybrid Plans In Washington

- Plans 3
- Balance of DB and DC
  - Employer pays DB; member pays DC
  - Flexible investment options, but with some guaranteed benefits
    - One percent multiplier instead of 2 percent in Plans 2
- DB portion, default rates, and target date fund options help manage benefit adequacy
- DC portion helps manage affordability
- Balances mobility and long-term employment

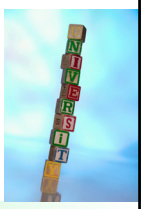


Washington Also Has Voluntary Supplemental Savings Plans

- Covered in recent presentations
- Allow members option to increase overall contribution rate
- Deferred Compensation 457
  - Members control contribution rate
  - Employees eligible if employer participates
  - All employers eligible, but not all have opted in
- Tax Sheltered Annuity 403(b)
  - Teachers, some non-profits, and some clergy
  - All K-12 employers eligible, but must opt in
  - Generally voluntary, but terms may vary based on collective bargaining

Higher Education Retirement Plans (HERPS) Are DC Plans

- DC plan administered by institutions and private vendors; not DRS
  - Function like a 401(k)
  - Provide portability
- Available for faculty and non-classified staff
- SCPP studied in 2011
- Recent changes
  - New hires no longer eligible for "supplemental benefit"
    - Guaranteed minimum benefits
    - DB element inside a DC plan
  - State contribution capped at 6 percent
    - Total employer contribution can exceed 6 percent



There Is Also Pending DC Legislation

- Most focus during session was on optional DC (ESSB 5851)
  - Passed Senate
  - Not heard in House
- Still alive for upcoming session
- Summary reflects ESSB version
- Bill history/text available here

Optional DC Plan (ESSB 5851)

- Creates new DC plan (PESP)
  - Optional for new hires
  - Optional transfer window for existing Plans 2/3 members
  - PESP members can transfer to Plan 3 on an actuarial equivalent basis
- Self-directed investment
  - Target date funds are default
- Contributions
  - Member: 5 percent until age 35, then 7.5 percent
  - Employer: 80 percent of member contribution, plus UAAL
- Annuity options

Fiscal Impacts For Optional DC (ESSB 5851)

Budget Impacts			
(Dollars in Millions)	2013-2015	2015-2017	25-Year
General Fund-State	($2.2)	($4.4)	($240.3)
Local Government	($1.2)	($2.9)	($163.0)
Total Employer	($3.5)	($7.5)	($436.2)

Note: We use long-term assumptions to produce our short-term budget impacts. Therefore, our short-term budget impacts will likely vary from estimates produced from other short-term budget models.

- Analysis is sensitive to count of members choosing PESP
  - Actual experience over 25-years could range from cost-neutral to savings over $900 million
- Please see the fiscal note for
  - Administrative impacts
  - Actuarial assumptions and methods, as well as additional context and details
  - Available here

Summary

- Different Plan Designs for Different Goals
  - There is no one-size-fits-all perfect plan design
  - Total benefits package: More than just core retirement plan
- Identify what you believe are the most important goals and risks
- Choose the design that's the best fit
- Ways to achieve goals and manage risks in any design
- Could be covered in future education opportunities