The Select Committee on Pension Policy

Pensions 102 – Plan Design

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Office of the State Actuary
"Securing tomorrow's pensions today."

DESIGN Means To Create…

- Pensions 102 is about plan design
- "To design" is to create or construct according to a plan
- Today's focus: retirement plans
  - A creative endeavor

Designing The Structure…

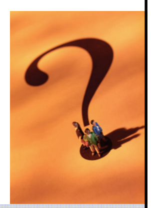
- Like building a home…
- Who will live there and what are their needs?
- What values will the home reflect?
- Is it affordable?

Washington's First Retirement Plans…

- Plans 1 opened in 1938 and 1947
  - Teachers' Retirement System Plan 1 (TRS 1)
  - Public Employees' Retirement System Plan 1 (PERS 1)
- Retirement plans were a fairly new concept
  - Social Security implemented in 1935
  - Few expectations for retirement plans
  - Provide a monthly payment for life

Many Unanswered Questions…

- How long will people live?
- How long will their pensions have to last?
- How might their needs change after they retire?
- How much will the plan cost over time?



What Were The Needs At The Time?

- Provide a level of financial security in later stages of life
  - Monthly payment for life
  - One leg of a "three-legged stool"
- Employer needs
  - Recruit workers
  - Manage workforce over time
- Employee needs
  - Receive a reward for service to the employer
  - Count on the promise

How Would Washington Afford These Plans?

- Members and employers would pay
  - Member would pay a fixed percent of pay
  - Employers would pay the balance
- Cost would be financed over time
  - Contributions would be invested
  - Investment returns would pay for largest share of the costs
- See Pensions 101 video

What Were The Plans 1 Designed To Do?

- Retirement benefit would reward a career
  - Stay 30 years to receive full benefit
  - No “normal retirement age”
- Members would exit workforce at end of career
  - Service is “capped”
  - Little incentive to stay past 30 years
- Nothing to address what happens after retirement
  - No inflation protection for retirees

What Does The Plan 1 Benefit Look Like?

- Monthly payment for life
- Based on a formula
- The benefit is “defined”
  - Amount is known because of the formula
  - Benefit payment is guaranteed for life

How Does The Formula Work Today?

Benefit = “Multiplier” X years of service credit
X salary average

- Multiplier is 2%
- Service credit
  - Years worked
  - Capped at 30
- Salary average
  - Average salary over the highest <u>two</u> years of service
  - Includes “cash-out” for annual leave

Plan 1 Features Popular With Members…

- Ability to get a full benefit after 30 years
  - Results in early retirements
- Ability to beef up pension benefit in final years of career
  - Salaries tend to be higher at end of career
  - Short salary average period
  - Annual leave cash-out
- “Other” benefits added
  - Disability
  - Death

Unpopular Features Of Plan 1…

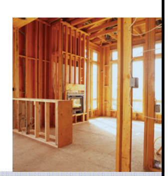
- Cost for employers
  - Earlier retirement costs more
  - Benefits paid out over longer periods of time
- More time to lose purchasing power
  - No inflation protection in original design
- Service cap
  - Little incentive to work past 30 years

Recap Of Plan 1 Design…

- Service-based
- Benefit “defined” by a formula
  - Service cap
  - Short period for averaging salary (two years)
  - Annual leave cash-outs
- Shared financing
  - State carries investment responsibility and risk
- No inflation protection in original design
- Other benefits
  - Disability
  - Death

Accommodating Change…

- Let’s go back to designing a home
- How do we keep it in good shape?
  - How will we maintain it?
  - How will we fix it?
- How long should the home last?
  - When do we remodel it?
  - When do we move to a new one?
- Can we afford it over the long-term?
  - Is our financing plan within our budget?
  - Can/should we change the financing over time?

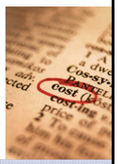


Examples Of "Remodeling" The Plans 1…

- Inflation protection
  - COLAs applied retroactively
  - Challenges to financing plan
- Workforce issues
  - Harder to keep experienced employees
    - Ability to retire earlier
    - Service cap
  - Expanded retire-rehire program in the Plans 1
- Remodeling added benefits

Views And Values Changed…

- Retirement benefit no longer viewed as a reward for a career
- Focus on income replacement when leaving the workforce
- Continued concern about inflation protection
- A desire for employers and employees to share equally in the costs



Affordability Of Plans 1 Questioned…

- Retroactive benefit increases, including COLAs
- People retiring early
- People living longer
- Underfunding by employer over time
- Emergence of unfunded liability for benefits already accrued
  - Technical term is unfunded actuarial accrued liability (UAAL)
  - Applies to past service

Can't Remodel To Cut Costs…

- Cutting plan costs usually means cutting benefits
- But pension benefits are contractual rights
  - Bakenhus case, 1956
  - See summary in SCPP's Orientation Manual
- Policy-makers can only add or replace benefits for existing employees
- To cut costs, open new plan for new employees

Moving To A New Home…

- By 1977, the Plans 2 opened ("open plans")
- Plans 1 closed to new employees ("closed plans")
  - New employees in PERS and TRS Plans 2
- Plans 2 are defined benefit plans
  - Benefit formula
  - Pensions paid for life
  - Promises in the nature of a contract
    - Employer still bears investment risk and responsibility to pay the benefit

How Were The Plans 2 Different?

- "Normal retirement age" (age based)
  - Provide income replacement at age 65
  - Age when employees expected to leave workforce
  - Social Security's normal retirement age at the time
- CPI-based COLA (3% maximum)
  - Helps protect against inflation
- Lower cost
  - Trade-offs

Other Differences In The Plans 2…

- Features to reduce plan costs
  - Salary average period changed from two to five years
  - Annual leave cash-outs no longer included
- No service cap
  - Get credit for all years worked
- Equal cost-sharing

Popular Features Of Plans 2…

- Lower cost
  - Members and employers share equally
- Inflation protection
  - CPI-based COLA
- Ability to "re-finance" and start fresh
  - Funding method does not allow UAAL
- No service cap

Some Features Unpopular With Members…

- Retiring at age 65
  - Pressure to lower the retirement age
- Longer period for averaging salary
- Absence of annual leave cash-out
- "Other" benefits not as generous
  - Disability
  - Death

Plans 1 | Plans 2

Plans 1

- Lower retirement ages
  - Desire to work longer
- No inflation protection
  - Desire for COLAs
- Affordability a challenge
  - Desire to spread cost to future generations

Plans 2

- Higher retirement ages
  - Desire to retire earlier
- 5-year salary average
  - Desire for 2-year
- Costs are contained
  - Desire for more benefits

1990s: A Time To Move Or Remodel?

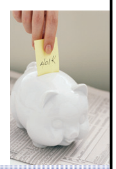
- Increased mobility in workforce
  - Flexibility
  - Portability
- Strong stock market
  - Desire to take advantage of higher investment returns
- Emerging value for more individual control
  - More member choice in retirement planning

Rise Of Defined Contribution Plans…

- Private sector shift
  - DB to defined contribution (DC) plans
  - Like 401(k)
- DC plans do not define the benefit
  - No benefit formula
  - No promise to pay the benefit for life
- DC plans allow members to define the contribution
  - Members choose how much to invest
  - Members choose how to invest
  - Members take the risk
    - Investment risk
    - Inflation risk

DC Plans Influenced Plan 3 Design…

- The first Plan 3 opened in 1996 (TRS)
- Hybrid: two designs in one
  - Features from DB and DC
  - Employer contribution provides DB-style benefit
  - Member contribution provides DC-style benefit
- Designed to be roughly equivalent in value to Plans 2
- New employees can choose Plan 2 or Plan 3



Mitigating Risk To Employees In Plans 3…

- Ability to invest in the state's retirement fund
  - Large public plans have generated better returns
- Option to purchase a lifetime payment ("annuity") from state
  - Less expensive than if purchased in private sector
- Employer-provided defined benefit as a "safety net"

Remodels To Plans 2 And 3…

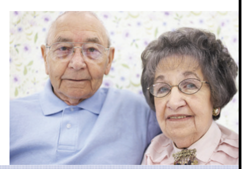
- Retire earlier than 65 if meet criteria
  - Original design: members take “actuarial reduction”
  - Lower monthly amount over longer period
  - Total benefit is the same
- Remodels reward those who stay 30 years and reach 55
  - 2000: Member’s monthly payment takes less of a “hit”
  - 2008: Unreduced pension at 62
- Members and employers share costs of remodels

Where Are We Today?

- Three “homes” for members
  - Plans 1 are closed but still have active members
  - Plans 2 and 3 are open with active members
- Employees with different plans work side-by-side
- Those in each plan see what the others have
  - “Pension envy”
  - “Cherry-picking”
  - “Leap-frogging”

Challenges For Policy Makers…

- Responding to desires of members
- Responding to changing needs
  - People living longer
  - Inflation
  - Workforce mobility
- Responding to different views and values
  - Purpose of retirement
  - Role of government, role of individual
- When to wait, fix, remodel or move?
  - Demolition not an option



Keeping The Plans Affordable…

- Not just a question of cost
- Gets back to what we learned about funding in Pensions 101
  - Regular payments over time
  - Fairness across generations
  - Long-term view
- Policy-makers faced with striking a balance
  - Benefits policy
  - Funding policy

What Drives Plan Design?

- Needs
  - Members, employers, society
- Views and values
  - Purpose of retirement
  - Roles of employers and members
- Affordability
  - Trade-offs

Questions?

Want To Learn More?

- Select Committee on Pension Policy (SCPP)
  www.leg.wa.gov/scpp
  See the 2008 Orientation Manual found under "Publications"
- Office of the State Actuary (OSA)
  http://osa.leg.wa.gov/
- Department of Retirement Systems (DRS)
  www.drs.wa.gov