# THE LEGAL REPORT

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## DEFINED BENEFITS DEFINED AND DEFENDED

This Legal Report is more of a . . . legal opinion . . . well actually more of a . . . personal opinion . . . well actually more of a . . . ok, let's just cut to the chase . . . bottom line is that I have something that I believe needs to be said and MAPERS just gave me another forum to say it. I just hope someone will listen. It is with great concern for the long term future of our state and the retirement security of its public employees, that I focus on the state of pension plans.

No, this is not another article about the declines and turmoil in the financial markets. I'll leave that for the financial professionals (although I've been known to provide an occasional investment comment every so often). I am, however, back on my soap box to defend the benefits of defined benefit plans against their continued attack by some who seek to trade in their defined benefit plans for defined contribution plans. A trade which I truly believe will end up costing retirement plan participants and the communities in which they live and work . . . dearly.

In these turbulent economic times, communities are making great efforts to make every dollar count, and get the "biggest bang for the buck." To that end, dollar for dollar, defined benefit plans provide the biggest bang for the buck.

This is not investment advice, but simply the end result of a familiar equation: B = C + I - E. The benefits ("B") provided under <u>any</u> long term benefit plan (e.g., both DB Plans and DC Plans), cannot exceed the contributions ("C") plus the investment returns ("I") less the administrative expenses ("E). A review of numerous studies and volumes of data indicates that the investment returns ("I") of DB Plans are significantly higher that DC Plans (i.e. 2% - 5%), and the investment and administrative expenses ("E") of a DB Plan are lower than DC Plans, therefore the amount of retirement assets available to pay benefits ("B") is significantly higher in a DB Plan. Similarly, in light of the above, contributions ("C") to a DB Plan would be significantly lower than the contributions to a DC Plan to provide the same level of benefits.

At this point, I can visualize critics of DB Plans jumping out of their seats. Some of may even be foaming at the mouth - if they've gotten this far (believe me, I've seen it!). I can hear it now, "Contributions to DB Plans are not fixed and our employer cost has gone through the roof," "There's too much volatility in the employer contribution rate," "All the risk in a DB Plan is on the employer, " or my personal favorite, "The private sector has dumped their DB Plans for DC Plans (i.e. 401K Plan) so we should follow step." I've certainly left out a few and could not print others, but are you ready for this . . . "For the most part, I understand **and** agree." If, however, we consider the research and studies, it is consistently demonstrated that DB Plans deliver, hands down, more retirement savings per dollar of contributions than DC Plans.

If you would be so kind as to indulge me the opportunity to share with you some additional thoughts in support of defined benefit plans (I'm just warming up now!).

Administrative Expenses

A DB Plan pays significantly less in investment expenses because all accounts are aggregated and the DB Plan enjoys economies of scale. Likewise, DC Plans generally have a higher benefit/account administrative expense ratio than DB Plans because it is more expensive to manage hundreds or thousands of small individual account than one large institutional account. Most DC Plans use a mutual fund platform where the range of expense is 1.0% - 2.0% of assets.[i] This depends as well on the options and features provided to plan participants.

The end result is that the greater the total administrative expense in a plan, the less money there is to invest and ultimately payout in benefits. Lower expenses have the same end result as higher investment returns. I have read numerous studies that demonstrate that the typical DC Plan has administrative expenses of 50 - 150 basis points (.5 - 1.5%) greater that the average DB Plan.[ii] The general rule of thumb suggests that for each 1% increase in expenses the final retirement benefit is reduced by 20%. Policy makers should identify all administrative expenses of their existing plan and those of any new plan under consideration. Note that many administrative expenses of DB Plans are difficult to identify and may be buried in the investment performance of the fund.

It is also noted that policy makers may consider a DC Plan cheaper because the employees pay the cost. In a DB, the costs are paid by the plan and to the extent needed for actuarial funding, must be made up by employer contributions. While in the short term policy makers may consider it a cost savings to shift the administrative costs of their DB Plan to employees by implementation of a DC Plan, I believe that as a result of the direct increase in the total amount of those costs inherent in a DC Plan, that ultimately the resulting reduction in retirement savings will cost everyone more money (i.e. the employer, the employee and the citizens). My rationalization for this argument is discussed in greater detail later in this article.

Investment Returns

The purpose of a retirement plan is not to empower employees, or create sophisticated investors or to make participants' wealthy. The chief purpose of a retirement plan should be to ensure a level of retirement income that reflects the employee's wage and tenure of service to the community. Numerous studies consistently demonstrate that the average employee and/or retiree investing their money in a DC Plan (or 401-K in the private sector) typically under-perform the investment returns of institutional DB Plans. In fact, I have yet to read of a single study demonstrating otherwise. While there are rare instances of individual employees generating superior investment returns, these are the exception rather than the rule.[iii]

I've heard employers say, that the employees in their community are smarter, or they're going to provide great educational programs. I think a good individual indicator of the potential success of employees investing their DC plan assets is to compare the average return of your current 457 plan members with your existing DB Plan. I suspect that the 457 plan returns are significantly lower than your DB Plan. I further suspect that if a DC Plan is put in place to replace a DB Plan, those same employees would, on average, be even more restrictive in their asset allocation decisions resulting in lower long term investment returns in their DC Plan account as compared with their 457 Plan account.

Longevity, Risk Pooling

The ability to pool longevity risk is a benefit of DB Plans that is often overlooked. Some people criticize DB Plans on the basis that if the retiree and named beneficiary die an early death, there are no further benefits payable to the estate or surviving children. Don't get me wrong, I love my kids but it is not a benefit to them if I exhausted my retirement savings, outlived my life expectancy and had to rely on them for support in my final years. Therefore, I believe the greater concern and focus should be,"what happens if my spouse and I out live our retirement savings?"

In a DB Plan my longevity risk is pooled with other members of the plan and benefits are funded based upon the participant's average life expectancy. Comparable funding in a DC Plan would mean that I would have a 50:50 chance of outliving my retirement savings. I don't know about you, but a 50:50 chance is not very good odds, especially since I plan on outliving my life expectancy just so that I can be a problem for my children (I have two teenage daughters right now, so I have fully earned this right!)

Now if your in a DC Plan and would like better odds, note the following comparable funding needed:

For 2:1 odds, you need 11% more in DC plan assets;
For 4:1 odds, you need 20% more in DC plan assets; and
For 10:1 odds, you need 26% more in DC plan assets.

Accordingly, the value created by a pooling longevity risk in a DB Plan based upon average life expectancies ranges from 10 - 25% in less required retirement savings to ensure a comparable level of benefits from a DC Plan providing benefits over your retirement lifetime.[iv]

Investment Risk Pooling

Every trustee knows the general rule that greater investment risk means greater investment returns. The role of the Board is to balance the risk/reward tolerances of the retirement board with the long term investment objectives of the retirement system. In a DB Plan, investment risk pooling also creates significant value which ultimately impacts the funding and payment of benefits from the plan. Individual DC Plan participants, especially in retirement years, have different risk/reward tolerances and liquidity needs, which ultimately reduce long term investment returns.

Portability/Leakage

Occasionally, I hear someone raise portability as a key desirable feature of DC Plans. While DC Plans do provide for greater portability, I'm not so convinced that the majority of public employees think portability is more important than retirement security. I acknowledge that DC Plan portability is preferable for shorter term (i.e., 8 - 10 years) and part-time employees. However, two-thirds of public employees work in career oriented rolls; education, public safety, corrections and the judiciary. A public employee retirement system should support the retention of competent and qualified employees. DC Plans do not reward or encourage longevity. Rather, I believe the portability feature of DC Plans will support the movement to other employment of the most qualified and motivated of our public employees.

The other public policy concern with DC Plans is that they provide little defense against "leakage" - whereby participant's cash out their retirement savings, take loans or lump sums, etc. The majority of terminating employees with a DC Plan as their primary retirement benefit, cash out their assets at the time of termination rather than rolling them over.

The key to the success of a DC retirement plan program, is early participation and long term compounding of contributions and investment returns. Portability and leakage operate to work against that success and unfortunately this often leads to less retirement income security, not more. Policy makers must fully consider what such leakage will have upon retirement income in the next century. If portability is a true concern, DB Plans can be designed to include a remarkable range and variety of innovative portability features without the leakage found in DC Plans.

Public Policy

Finally, why would we base any public employer decision on the trends we see in the private sector without fully analyzing the differences between the private sector and public sector. There are fundamental, significant differences in private sector DB Plans as compared to public sector DB Plans (i.e., Internal Revenue Code provisions, ERISA, DOL). These regulations increase the volatility of funding levels and contribution requirements as well as impose a substantial cost and administrative burden on private sector employers. A corporation's stream of revenue is less predictable and reliable than a governmental entity's tax revenue which further complicates the ability to plan for required contributions. Additionally, corporations have greater flexibility than governmental employers to recruit and retain essential workers. The public sector workforce often spends their entire career with one or two public employers. This is more atypical in the private sector.

I believe, from a public policy standpoint, the public sector has and should continue to demonstrate to the private sector what an appropriate retirement program should encompass. The decline in DB Plan coverage has diminished the nation's retirement readiness. Many DC Plan participants arrive at retirement with insufficient assets to last the remainder of their lives. DC Plans alone are particularly perilous or when the participants are not Social Security eligible. A 2004 Congressional Research Service study found that only half of older workers in 401-K plans had accumulated enough to provide $5,000 annually, while public plans paid on average of $20,000 annually in 2005.[v]

I do not understand why our public employers would want to pursue a policy that leads to less retirement security. I have sat through many city council, township and county board meetings and witnessed hours spent debating on dog parks, maximum garage door heights, yard sign-age, etc., but yet little time is spent on attaining a true understanding of the different retirement plans and options available. Instead it's a quick and easy answer: "All new hires participate in a new DC Plan with a 10% fixed employer contribution". . . Done! In most instances this provides little cost relief in the near future and may in fact exacerbate the current funding predicament. Those that believe that DC Plans cost less likely fail to fully recognize that they also deliver much less in retirement in retirement income.[vi]

Therefore, shouldn't we be asking ourselves: "Isn't there another way to deal with these issues?" I believe the debate should focus on how to restore reliable, sustainable benefits to those who have lost them, not eliminating DB Plans from those that still have them. Rather than trading in your expensive, perhaps "broken", DB Plans for a shiny new DC Plan for new hires, perhaps the focus should be on fixing our existing DB Plan (or establishing a shiny new one) for new hires. Start with a detailed historical review of your current DB Plan to gain a complete understanding of how amendments and policy decisions have impacted the plan since its inception. This review should include benefit levels, funding policies, employer and employee contribution levels, funding holidays, investment policies and returns, early retirement incentives, and actuarial assumptions and methodologies. With a greater understanding of how your existing plan has become too expensive or "broken", make the appropriate changes and consider adoption of long term policies that prohibit or alert future decisions makers from making the same or similar mistakes in the future.

While the implementation of a DC Plan is certainly an easier decision and perhaps appropriate in certain circumstances, if you're looking to provide the highest level of benefits you can buy for the least amount of required contributions, then I believe a DB Plan is the clear answer. But be prepared, you've got some work to do to develop the appropriate plan for your community. I believe our public servants are worth the extra effort, and a well designed and funded defined benefit plan is worth every buck.

[i] *Myths & Misperceptions of Defined Benefit and Defined Contribution Plans,* White Paper publication by the National Association of State Retirement Administrators, page #16 (November, 2002, updated March, 2003).

[ii] *Myths & Misperceptions of Defined Benefit and Defined Contribution Plans,* White Paper publication by the National Association of State Retirement Administrators, page #15 (November, 2002, updated March, 2003); *The Top Ten Advantages of Maintaining Defined Benefit Pensions,* NCPERS Research Series, page #11 (May, 2007).

[iii] A study of the Nebraska Public Employees Retirement System in 2000 found that for the period 1983 - 1999, their DB Plans generated an average return of 11% while the system' DC Plan participants were averaging 6%. *Myths & Misperceptions of Defined Benefit and Defined Contribution Plans,* White Paper publication by the National Association of State Retirement Administrators, page #8 (November, 2002, updated March, 2003); *The Top Ten Advantages of Maintaining Defined Benefit Pensions,* NCPERS Research Series, page # 7 & 8 (May, 2007). In the West Virginia Teachers' Retirement Plans for the period 2001 -2006, the DB plans generated an average return of 6.13% while the system's DC plan participants were averaging 3.39%. *Defined Contribution Experience in the Public Sector,* as published in the International Foundation of Employee Benefit Plans (IFEBP) Benefits and Compensation Digest, page # 24, www.ifebp.org, (Vol.44,No.2 February, 2007).

[iv] *Defined Benefit Plans: Still a Good Solution?,* Donald Fuerst, Mercer Human Resource Consulting publication, page #2 (April, 2004)

[v] *Voice: The Impact of Current Trends on the Future Economy,* Paul Zorn and Keith Brainard, Plan Sponsor Magazine (November, 2006)

[vi] *Defined Benefit Plans: Still a Good Solution?,* Donald Fuerst, Mercer Human Resource Consulting publication, page #3 (April, 2004)

## RESOURCES/WEBSITES

**www.ncpers.org**
**www.nasra.org**
**www.nctr.org**
**www.publicfundsurvey.org**