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SENATE FINANCE & CLAIMS

Exhibit No. 3

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Bill No. SB328 – DC Plan SB328

2011 Legislative Session
Senate Finance & Claims Committee
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Senate Bill No. 328 – Require PERS New Hires to be in Defined Contribution Plan

Overview

- This bill impacts only the Public Employees' Retirement System (PERS). PERS is the largest of the eight defined benefit plans administered by the Public Employees' Retirement Board (PERB).

- PERS covers state agencies, counties, cities, local government agencies and non-teaching staff in the University System and school districts.

- PERS Membership

PERS Membership		
State Agencies	10,815	38%
Universities	2,626	9%
Counties	5,438	19%
Cities	3,238	11%
Other Agencies	1,207	4%
School Districts	5,510	19%
	28,834	

- PERS currently allows new hires 12 months to choose between the defined benefit retirement plan (DB) and the defined contribution retirement plan (DC).

- As of June 30, 2010 there were 28,834 active members in the DB and 2,018 members in the DC. (6% of total PERS membership has chosen the DC)

- Other states have created DC plans for some or all of their employees. Experience of those states is that members prefer DB plans. Some states with DC plans have studied the benefits offered and concluded that the DC plans are costly and not meeting retirement goals. Nebraska and West Virginia have recently switched back to a DB plan from a DC plan.

- PERB believes that "one size does not fit all". They believe in providing the plan choice available to members today.

Time Needed to Develop and Study New Plan

- Proposals of this sweeping change need time for research and development to avoid unintended consequences.

- The SAVA Interim Committee is the Committee that vets proposed retirement bills. Senator Lewis was a member of the Interim Committee. This bill was not vetted through SAVA.

- The 2009 Legislature passed HB 659 requiring an interim study the statewide retirement plans and providing an appropriation. An actuary was hired to provide several plan alternatives. ***SAVA did <u>not</u> propose closing the current defined benefit retirement plan and requiring a defined contribution retirement plan.***

- SAVA did recommend the Board's proposal of HB 122 to the legislature with a recommendation to remove the funding mechanism.

- HB 122 decreases normal cost in the DB plan to 9.59%. The normal cost in this DC bill will be 11.39%.

- The amount of money over the Normal Cost that is received and the Plan Choice Rate is used to pay off the unfunded liability in the DB plan.

<u>Defined Contribution (DC) vs. Defined Benefit (DB) Plans</u>

- DB plans do not provide extravagant benefits. The average PERS retiree earns $1,049/month.

- DB plans provide a guaranteed lifetime benefit at retirement based on a formula that reflects salary history and service.

  DC plans do not provide for a guaranteed lifetime benefit. Contributions and actual investment earnings accumulate. The participant's annual retirement income is whatever the accumulated assets can provide over the retiree's lifetime.

- DB plans have been around for over 100 years because they have many positive attributes, especially in the current economic environment. Montana's Public Employees' Retirement System has been in place for 66 years.

- Traditional DB plans better ensure retirement security for employees and are a cost effective recruitment and retention tool for employers.

  Studies have shown that DC participants do not save enough for retirement. They take their money when they move from job to job and often, rather than rolling it to their new employer's retirement plan. At the end of their career they can purchase an annuity at a cost plus fees to have a lifetime benefit and often that annuity is not enough for a secure retirement.

- The average person does not know how to diversify their portfolios; are risk adverse and invest emotionally.

DB plan assets are professionally managed; providing greater returns.

- DC members must individually bear the costs and benefits.
  DB members share the costs and benefits.

- DC members have to rely on market timing when planning their retirement.
  DB plan assets are pooled and designed to withstand market volatility.

- DB plans cost an average of 31 basis points (31 cents per $100 of assets).
  DC plans cost between 96 to 175 basis points.

- The actuarial assumed rate of return of 7¾% is very realistic. It is an average over time. It is based on the investment allocation and objectives of the Board of Investments. FY 1994 – FY 2008, the average rate of return was 8.47%. The BOI's consultants reported in December 2010 that given the risk and return make-up of the portfolios, the average return expectation is 7.93% over time.

- Markets are improving.
  - FY 2010 rate of return – 12.87%.
  - FY 2011 through January 2011rate of return – 17½%.

- Most DC members are unable to achieve these returns on their own. The average PERS member does not have the time to compound their investments.

Advantages of a DB Plan

- ❖ DB plans are efficient. They:
  - are less expensive to administer
  - have pooled risk
  - are managed by investment professionals
  - have diversified portfolios
  - resulting in higher returns.

- ❖ Guaranteed, lifetime benefits reduce need for public assistance.

- ❖ Guaranteed, lifetime benefits support our local economy by allowing retirees to continue to purchase necessities during difficult economic times.

DC Plans are not as Beneficial as DB Plans for most PERS Members

- ❖ The DCRP is a good, attractive plan for young employees who have time to grow their retirement.

- ❖ PERB believes that a DB plan is advantageous for most PERS members.

- ❖ PERS members are older and don't have the benefit of compounding interest over time.

The average PERS member:

- is 48.9 years of age
- earns $38,281/year
- has 9 years of service credit
- retires at 59.2 years of age
- retires with 19 years of service credit
- earns $1,049/ month in retirement.

- ❖ Instead of trying to diminish the retirement security for public servants we should be promoting retirement security for all.

Closing the PERS-DB Plan

- Closing the PERS-DB plan to new hires is the worst alternative for addressing the current funding issues.

- Closing the PERS-DB plan does not reduce the unfunded actuarial liabilities (UAL).

- A stable membership and income stream is needed to fund the PERS-DB plan.

- Since new hires will not be in the DB plan, the payroll base will begin to decline immediately. Less money will be available to pay down the UAL.

- The financial burden as a percent of payroll will increase. This will be compounded by a change in methodology for valuing the system now that it is no longer an open on-going retirement plan.

- The investment returns will not be sufficient to pay increasing retirement benefits on a declining payroll.

- The PERS-DB plan must continue to operate until that last new hire retires dies and the new hire's beneficiary dies. This could be 75 years into the future.

- Closing the current plan has a detrimental impact on the PERS-DBRP funding:
  - Payroll decreases from $1.15B to $0.31B in 2030.
  - Funding status plummets from 74% today to 7% in 2030.
  - Actuarial Accrued Liability increases from 5.24B to 8.65B in 2030
  - Annual required contributions (ARC) increases from 22.3% today to 223.5% in 2030.

- **The fund will run out of money; creating a much deeper hole than we are in today. <Handout – Assets vs. Liabilities>**

- Because of the declining payroll. The current method of calculating the amortization payment will need to be changed to reflect a closed system. This will compound the cost of funding the DB UAL.

- Currently a member in either the DB or DC plan must be vested to be eligible for disability benefits. Under this proposal disability benefits for DC members are available on day one. The disability trust fund will not be sufficiently funded over time.

- You may have attended the presentation on the Utah Hybrid plan by Senator Dan Liljenquist. The take-aways from his presentation:
  - Utah performed a study over 2 years.
  - Utah recognized they wanted a secure retirement plans for their public servants.
  - Utah created a new "tier" to ensure that funding continued for the DB plan.
  - Utah realized that contributions needed to be increased to pay the actuarial required contributions (ARC).
  - Utah committed to continued funding of the current plan.

SB 328 Positive Aspects

- The bill recognizes there is a contract right for current members.

- The bill recognizes the need to pay the unfunded actuarial liability in the DBRP; however, the funding is not adequately addressed.

- The bill recognizes the need to request IRS approval.

SB 328 Technical Concerns

- Section 1 – speaks of "additional contributions" – does this mean members can contribute over the 'defined' amount?

- Section 2 – allows an election for "certain members" – non-vested members. Is this an equity issue?

- Section 4 & 5 – states that the Governor must include the necessary funding of the PERS-DBRP in the preliminary budget. This does not adequately address the funding issue. ***The funding source is not identified nor guaranteed.***

- Section 6 – "initially hired" is a new definition. Should this be in PERS definitions Chapter 3, rather than Chapter 2, which addresses all retirement plans administered by the PERB? As currently addressed it might create unintended consequences.

- Section 9 & 21 – members vest immediately. There are no longer forfeitures of employer contributions if a member leaves covered employment before vesting. Forfeitures help offset administrative costs.

- Vesting members immediately makes them eligible for disability benefits from day one. Disabled DC members are eligible for a monthly benefit calculated similarly to the DB members. They are eligible for this monthly payment until they can access their DC account balance at age 60 or age 65 if the disability occurs after age 60.

- Section 19 – the interest rate for transfers is 8%. This is the rate for the original transfer period for current members, many of which were long time PERS members. This rate should not be more than the actuarial assumed rate of return of 7¾%. Perhaps, it should be based on a short-term earnings rate.

- Section 22 – Employer allocation. The plan choice rate (PCR) is repealed. The PCR pays the impact on the unfunded actuarial liability due to members leaving the defined benefit plan. The proposal does allocate 0.27% of employer contributions to the DBRP and to the long-term disability plan trust fund. However, the language "in the following order" is removed. It is unclear how it should be allocated.

- Plan Choice Rate – is a mechanism to allow the 529 employers to continue to pay their unfunded liability obligation to the DB plan. The legislature had three choices to pay this obligation when the DC plan was enacted.
  - Have the state pay the obligation.
  - Increase employer contributions so the employer would pay the obligation.
  - Decrease the amount of employer contributions to the members account to pay the obligation.

  The legislature chose the last option. As of June 30, 2010 there continues to be $14.8 million dollars the employers owe to the defined benefit plan.

- Cost to provide plan choice education for non-vested members - Pubic retirement systems assets are to be held in trust for the exclusive benefit of the members of the trust. How will the expense for this plan choice education be paid for? The original plan choice education for the PER-DC plan was provided through a loan to the DC plan.

<u>Constitution Language – Article VIII Section 15</u>

Constitution of Montana

-- Article VIII -- REVENUE AND FINANCE

Section 15. Public retirement system assets. (1) Public retirement systems shall be funded on an actuarially sound basis. Public retirement system assets, including income and actuarially required contributions, shall not be encumbered, diverted, reduced, or terminated and shall be held in trust to provide benefits to participants and their beneficiaries and to defray administrative expenses.

(2) The governing boards of public retirement systems shall administer the system, including actuarial determinations, as fiduciaries of system participants and their beneficiaries.

History: En. Sec. 2, Const. Amend. No. 25, approved Nov. 8, 1994.

Closing

- **With this bill the PERS-DBRP goes broke long before the last benefits are paid out.**

- The Public Employees' Retirement Board respectfully recommends a "Do NOT Pass" on SB 328.

- I will remain available for questions.

- Thank you.