Does the Montana PERS Defined Contribution Retirement Plan Meet Design Gold Standards?

Gold Standard	PERS DCRP
Defined Plan Objectives *Ensure plan objectives are defined in writing as part of a comprehensive benefits policy statement.*	No
Communication and Education *Ensure members are educated on the available choices and have all relevant information to make competent retirement choices.*	Some
Auto Enrollment *Enroll new employees into the DCRP Investment Plan by default.*	No
Adequate Contributions *Replace approximately 80% of a worker's final salary.*	Yes
Retirement Specific Portfolio Design *Offer "one-touch" investment options for employees who are not sophisticated investors and do not want to avail themselves of in-plan investment advice.*	Yes
Benefit Portability *Safeguard the ability to recruit highly mobile 21st Century employees.*	Some
Offer Distribution Options *Provide members with a variety of asset distribution methods while limiting borrowing.*	Some
Disability Coverage *Offer a separate disability insurance benefit from a quality insurer.*	Yes

Analysis by Pension Integrity Project at Reason Foundation

Objective	Gold Standard	*PERS DCRP*
Defined Plan Objectives	Defines objectives in writing as part of a comprehensive "benefits policy statement" or at least within a "retirement plan policy statement."	*There is little reference in the PERS DCRP material that specifically speaks to plan objectives. The DCRP plan document does refer to it being a "pension plan" without further clarification or definition other than for purposes of federal IRC compliance. This statement falls short of stating plan objectives as it is too general and without supporting detail.*
Communication and Education	Educated members on the available choices and relevant information needed to make competent retirement decisions.	*PERS provides a variety of education materials to new covered employees regarding the choice between the PERS defined benefit and DCRP options. These include both digital and available print summary plan descriptions and basic benefit accrual examples for the plan choices. Choice seminars for new employees are provided. No benefit comparison modeling tools were identified which would better emphasize and demonstrate how the DCRP could be a much better choice for shorter service younger employees.*
Auto Enrollment	Defaults members into a defined contribution retirement option if no other option is selected upon hire.	*Although mandatory participation in either the MPERS DB or DCRP plans is required for new hires, currently the DB plan is the default option. Setting the DB plan as the default ignores high turnover trends and limits the opportunity to accumulate retirement savings to a small group of full career public employees at the expense of non-career workers.*
Adequate Contributions	Replace approximately 80% of a worker's final salary.	*Currently, the employer contribution towards the DCRP is set at 8.77% of covered compensation while the employee contribution rate is set at 7.99% of covered compensation. A combined DC contribution above 16% exceeds the 10%-15% target range needed to meet the best practice standard.* *Note: The employee contribution to the DCRP is statutorily tied to the employee contribution rate for the DB plan under MCA Section19-3-314(2). While a uniform contribution rate for employees regardless of the DB vs. DCRP choice may have been a rationale when the DCRP was enacted, it is unusual to have the DCRP employee contribution go up or down depending on the actuarial funding status of the DB plan. Consideration should be given to separate the contribution policy of the DCRP from the DB plan.*
Retirement Specific Portfolio Design	Offer "one-touch" investment options for employees who are not sophisticated investors and do not want to avail themselves of in-plan investment advice.	*The DCRP provides for default investment into an age-based target date investment fund. In addition, participants may choose to use a menu of investment options with a "Do it myself" or "Help Me Do It" tool. The investment menu includes a series of Target Date plus 18 other investment funds across the investment risk and return spectrum.*
Benefit Portability	Safeguard the ability to recruit highly mobile 21st Century employees.	*Vesting in the employer contribution after 5 years of service matches the vesting period for the DB plan and is consistent with ERISA minimums for private sector employers. It is, however, recommended that DC plan vesting periods be shorter than 5 years, with immediate vesting preferred in order to maximize portability. The Montana University System-Retirement Plan, for example, has immediate vesting.*
Offer Distribution Options	Provide members with a variety of asset distribution methods while limiting borrowing.	*The DCRP allows lump sum, periodic payment, life expectancy distribution options. While the DCRP plan document does permit life annuity products, PERS currently offers no annuity options. The absence of a life annuity set of options is an important missing component of plan features needed by DCRP participants to effectively address their longevity risks in retirement. The DCRP does not allow plan loans, which is a best practice for core defined contribution plans.*
Disability Coverage	Offer a separate disability insurance benefit from a quality insurer.	*DCRP members have part of the employer 8.77% contribution allocated to provide disability benefits from the Montana PERS DB plan.*

Analysis by Pension Integrity Project at Reason Foundation

PUBLIC PENSION DESIGN OPTIONS FOR FUTURE MONTANA EMPLOYEES

PUBLIC COMMENTS REGARDING HJ 8 AND THE INTERIM STUDY OF MONTANA'S PUBLIC PENSION SYSTEMS

Prepared by:

Pension Integrity Project at Reason Foundation

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reason FOUNDATION

About the Pension Integrity Project

We offer pro-bono technical assistance to public officials to help them design and implement pension reforms that improve plan solvency and promote retirement security, including:

- *Customized analysis* of pension system design, trends
- *Independent actuarial modeling* of reform scenarios
- Consultation and modeling around *custom policy designs*
- Latest pension reform *research and case studies*
- *Peer-to-peer mentoring* from state and local officials who have successfully enacted pension reforms
- Assistance with *stakeholder outreach*, engagement and relationship management
- Design and execution of *public education programs* and media campaigns

A REVIEW OF RETIREMENT PLAN DESIGN OPTIONS FOR NEW HIRES

Reason Foundation

This is for informational purposes only and not an endorsement of any particular reform concept.

Protecting Benefits Through a Transition

Defined Benefit Pension Plans Are Not Like Social Security

- ✓ Healthy pension plans use employer and employee contributions, combined with anticipated investment earnings, to fully fund promised benefits in advance.
- ✓ Pension plans are designed to be ***prefunded***, meaning each year the state and employees are responsible for paying enough into the plan to cover the present value of all future pension benefits earned that year.
- ✓ Employee contributions are the property of the employee and should not subsidize current retirees.

New Members Are *Not* Required To Keep Public Pension Plans Solvent.

There is No "Transition Cost" with New Retirement Plans

- ✓ There is no inherent ***"transition cost"*** when adopting a new retirement plan design for new hires, and there is no legal requirement to increase contributions in transitioning to a new plan.
- ✓ Unfunded pension benefits would still need to be paid off by the state along with the costs to fund new accruals in both the legacy and new pension plans, but there is no additional cost inherent to offering additional retirement plan options to employees. Indeed, Montana currently offers retirement choice.
- ✓ Like today, growth in unfunded liabilities within the legacy pension plan/tier would simply be a result of the state continuing to maintain unrealistic actuarial assumptions, weak funding policies, overly lengthy amortization policies, and other drivers of pension debt in the legacy pension plan.

Planning For A Transition To A New Tier

- ✓ When opening a new retirement plan—or providing a choice of plans— to new hires, *policymakers must have a strategy in place to continue paying down legacy debts* at either the existing or an accelerated pace to ensure long-term cost savings.
- ✓ The most effective way to do this is for the employer to make a supplemental payment toward unfunded liabilities for every new hire, just as if the reform never happened and the legacy pension was still the only retirement option.

DC+DB CHOICE PLAN DESIGN

DC+DB Pension Choice Overview

*The **DC+DB Choice** plan design concept leverages Montana's current benefit structure to comprehensively address legacy challenges while improving the opportunity for non-career members to effectively save for retirement.*

Featuring for New Hires:

- A new defined benefit option with the same level of benefits, but features to reduce long-term governmental risks and costs
- An improved define contribution option for non-career workers
- Automatic enrollment of new employees to the improved defined contribution option unless otherwise indicated by the employee

For Legacy Employees and Liabilities:

- The current defined benefit remains for legacy workers and retirees, with **no changes** to current member and retiree benefits
- More probable actuarial assumptions and accelerated debt payment policies that reinforce the state's commitment to fully funding all promised benefits while minimizing long-term costs to taxpayers

DC+DB Choice Plan Design

Giving all **new** workers the choice between a new reduced-risk DB plan and a well-structured DC plan.

DC Plan

- Opened to all new workers
- 7% required employee contributions
- 7% required employer contributions

New DB Plan

- More realistic assumed rate of return
- Cost sharing for all new normal cost and amortization payments
- Same underlying benefit as the existing DB plan

- Defaults will largely determine the share of incoming members that end up in either the DB or DC plan.

How a DC+DB Choice Reduces Risk

Regulates cost better than the existing standalone DB plan, because the risk-managed DB benefit will not be as vulnerable to market volatility and unpredictability

Limits risk by increasing the number of those taking the DC option, which means more workers accruing stable, predictable benefits

States that Use a DC-Choice Plan:

Arizona
Colorado
Michigan
Pennsylvania
Utah
Florida
South Carolina

Any new retirement plan for new hires would need to be paired with a sustainable plan to pay down legacy unfunded liabilities.

Defined Contribution Plan Best Practices

1. Contributions Should Meet Benefit Adequacy Standards

- Financial experts strongly recommend contributions of 10 to 15 percent of pre-tax earnings into a retirement account for those participating in Social Security.
- Older workers with a closer retirement horizon and inadequate savings may need to contribute even more.

2. Encourage Use of Target Date Funds

- Well-designed DC plans should also offer the correct age-appropriate investment mix. This is generally accomplished by using target date funds that adjust investment risk to the employee's retirement horizon to protect the value of the account from market fluctuations as the worker nears retirement.

3. Expand Lifetime Income Options to Improve Retirement Security

- The mix of proprietary investment funds and reasonably priced target-date funds give participants "one-choice" options.
- Guaranteed investments should be included in the target-date portfolio constructions, as well as options like deferred annuities.

Defined Benefit Reform Best Practices

1. **Adopt Better Funding Policy, Risk Assessment, And Actuarial Assumptions**
   - Lower the assumed rate of return to align with independent actuarial recommendations.
   - These changes should aim at minimizing risk and contribution rate volatility for employers and employees.

2. **Establish A Plan To Pay Off The Unfunded Liability As Quickly As Possible**
   - The Society of Actuaries Blue Ribbon Panel recommends amortization schedules be no longer than 15 to 20 years.
   - Reducing the amortization layering period would save the state billions in interest payments.

3. **Ensure Risk is Shared Equally Across Members and Employers**
   - Sharing the responsibility of pre-funding retirement benefits and cost-of-living adjustments aligns both major stakeholders in the need to balance cost and effective risk mitigation.
   - Public pension plans featuring automatic adjustment mechanisms that respond to market, and funding performance are generally less political and better funded than their peers.

DC+DB HYBRID PLAN DESIGN

Overview

*The **DC+DB Hybrid** plan design concept pairs a predefined lifetime benefit with an individual retirement savings account.*

Hybrid Retirement Benefit = **Defined Benefit Formula** + **Defined Contributions to Member's Savings Account** + **Investment Earnings on Contributions in DC Account**

*The **current retirement plan remains intact** for all active members and retirees without change or interruption. Fully funding all earned benefits is required for effective reform.*

What is a Hybrid Retirement Plan?

Benefits

- A standard hybrid retirement plan design provides members with a guaranteed return plan—a risk managed defined benefit pension with a lower multiplier than a traditional pension—along with an individual investment account.

Investments

- Assets of hybrid retirement plans are separated into two pools: a defined benefit pool and a defined contribution pool.
  - ✓ The defined benefit pool is combined with other members' assets and invested at the direction of the board trustees as plan fiduciaries.
  - ✓ The defined contribution pool is segmented from other members' assets and professionally managed in an employer-sponsored retirement system.
- The employer bears the investment risks associated with the defined benefit but bears no risk for the defined contribution pool of assets.

Lifetime Income

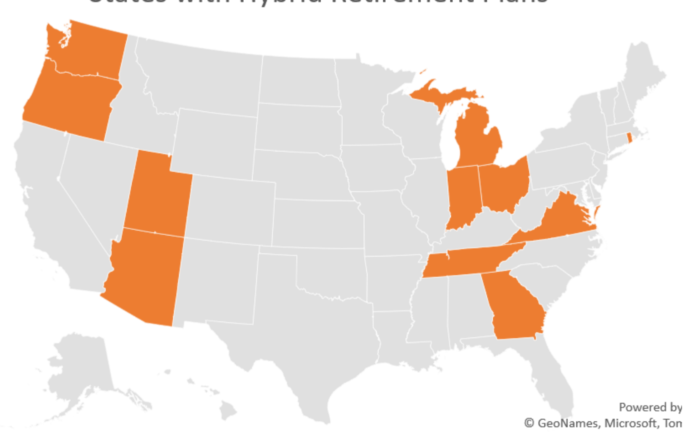
- Hybrid retirement plans offer lifetime annuities through the defined benefit portion of the benefit and provides an additional retirement savings (defined contribution) account credited through contributions and investment returns.
- At retirement, the member may choose to withdraw the lump sum of their defined contribution account or purchase an annuity.

Benefits of a Hybrid for Employers

Limits risk better than a traditional DB plan, because the guaranteed DB benefit is smaller and thus exposed to less market risk.

Regulates cost by predetermining employee and employer contributions to the DC. These costs do not rise or fall with investment earnings, making them appealing as another source of guaranteed pension dollars."

States with Hybrid Retirement Plans



For many states and municipalities, the unfunded liabilities of traditional defined-benefit pension plans present an increasing challenge to their budgets and credit rating.

Benefit of a Hybrid for Employees

- **For non-career employees** a hybrid is a far better choice than a traditional DB pension plan.
- Hybrids allow the DC portion of the benefit to **go with the employee** if they change careers.
- A member of a traditional DB pension system is only entitled to a **refund of the contributions in their retirement account** if they choose to change careers prior to vesting.

Hybrid Example – Federal Employees

Federal Employees Retirement System (FERS)

- All federal employees hired after 1/1/1984 are in the hybrid.
- Defined Benefit Pension
  - ✓1% multiplier x years of service x final average salary
- Defined Contribution – Thrift Savings Plan
  - ✓Members can contribute any amount up to the annual IRS limit.
  - ✓Employers automatically contribute 1% and will match up to 5% total.

Conceptual Hybrid Plan Basics

Defined Benefit Components

Employer Contributions:	Actuarially Determined
Employee Contributions:	Actuarially Determined
Vesting Period:	5 years
Benefit Formula:	(Years of Service) x (1%) x (Final Average Salary)
Final Average Salary:	Average of Highest 60 Consecutive Months of Pay
Cost of Living Adjustment:	Tied to local CPI, capped at 2%
Retirement Eligibility:	65 Years of Age

+

Defined Contribution Components

Employer Contributions:	Minimum 3%, matching up to 5%
Employee Contributions:	Minimum 3% Up to IRS Annual Limit
Vesting Period:	50% - Year 1 75% - Year 2 100% - Year 3
Retirement Eligibility:	65 Years of Age

Defined Benefit Rules

Assumed Rate of Return:	6% (max)
Discount Rate:	6% (max)
Debt Amortization Policy:	10-year, layered, level dollar
Cost of Living Adjustment Policy:	No COLA if plan drops below 90% funded.

CASH BALANCE PLAN DESIGN

What is a Cash Balance (CB) Retirement Plan?

Cash balance retirement plans are designed to guarantee asset growth while providing a steady accrual rate, offering members portability, and ensuring a path to retirement security for all types of employees.

- **Benefits -** A standard cash balance plan design provides members with their own individual retirement account within which they contribute a portion of their salary along with their employer, who adds an additional predetermined annual interest credit.
  - Both traditional defined benefit (DB) pensions and cash balance (CB) plan designs are examples of guaranteed return plans.
  - A CB designed plan defines a member's benefit as a constantly growing account balance, while a traditional DB pension plan defines a member's benefit using an accrual formula based on salary and years of service.
  - Cash balance plans credit a member's account each year with a "pay credit" (% of pay) and an "interest credit rate" (either a fixed rate or a variable rate linked to some formula).

- **Investments -** Assets of cash balance plans are pooled and professionally managed in a government-sponsored retirement system. Thus, the employer bears the investment risks.
  - The interest credit functions like a DB mechanism in that this interest credit is guaranteed, usually at or just above the risk-free rate, and any plan investment experience below the assumed rate is borne by the employer.

- **Life Annuities -** Cash balance plans are required to offer employees the ability to receive their benefits in the form of lifetime annuities.
  - When a member elects to retire, their annuity benefit will be based on their final account balance. Conversely, most cash balance plans allow the members the flexibility to simply take a lump sum of their account balance in lieu of receiving an annuity.

Cash Balance Retirement Benefit
=
Annual Employee Contributions
+ Annual Employer Contributions
+ Annual Interest Credit
+ Upside Sharing

Benefits of a Cash Balance Plan for Employers

Fixed contributions generally benefit the employer's ability to forecast and manage costs over the long-term.

Reduces risk of accruing unfunded liabilities on behalf of new members.

States With At Least One Cash Balance Plan:

California
Kansas
Kentucky
Nebraska
Texas

Allowing new hires to join a cash balance plan has no impact positively or negatively on current members or the plan's unfunded liabilities associated with current members and retirees.

Any new retirement plan for new hires would need to be paired with a sustainable plan to pay down legacy unfunded liabilities.

Benefits of a Cash Balance Plan for Employees

<u>Portability</u> allows members to take their full account balance with them whenever they leave public employment.

<u>Return Guarantees</u> offer predictability to plan members by removing much of the investment risk, yet still can offer upside gainsharing during years of extraordinary investment performance.

Cash Balance Example – Kentucky Retirement	
Employer Contribution Rate:	4%, 7.5% for public safety
Employee Contribution Rate:	5%, 8% for public safety
Interest Credit:	4%
Upside Sharing:	75% (of five-year average returns above 4%)
Vesting Period:	5-Years

<u>Turnkey Options</u> allow members to lean on investment professionals and removes the need for members to manage their own investment portfolios.

- In a CB plan, the employee and employer contributions are co-mingled and the state manages the investments in the plan just as it does in a traditional DB pension plan.

Cash Balance Design Costs vs. Risks

Costs:

- A cash balance plan with fixed employer contributions and a guaranteed interest crediting rate (+ upside share) that is lower than the current assumed investment return assumption could reduce employers' direct costs of providing lower-risk—but still guaranteed—benefits that resemble traditional DB pensions.

Risks:

- Similar to a DB pension, CB plan assets are managed by the employer, who bears the investment risks.
- Yet, setting a guaranteed rate benefit reduces downside risks for employers by removing the plan's reliance on market and demographic assumptions.
- Employees also enjoy a contribution floor guarantee and benefit from upside sharing of investment returns above the floor.

Cash balance plans can still accrue unfunded liabilities if investments severely underperform; however, risks are lower compared to a DB design that is subject to gains and losses from actuarial experiences.

FRAMEWORK FOR SOLUTIONS & REFORM

Objectives of Good Reform

Keeping Promises: Ensure the ability to pay 100% of the benefits earned and accrued by active workers and retirees

Retirement Security: Provide retirement security for all current and future employees

Predictability: Stabilize contribution rates for the long-term

Risk Reduction: Reduce pension system exposure to financial risk and market volatility

Affordability: Reduce long-term costs for employers/taxpayers and employees

Attractive Benefits: Ensure the ability to recruit 21st Century employees

Good Governance: Adopt best practices for board organization, investment management, and financial reporting

4-Part Pension Debt Mitigation Plan

Pension debt is a concern for all Montana policymakers, taxpayers and retirees, current and future, because its cost seeps through city and state budgets, smothering community programs like spilled oil on vegetation. Like an oil spill, there must be a clear process to end the emergency and set all impacted parties on a better path forward.

Part 1: ***Cap the Spill***

- Launch Improved Retirement Benefit Options to Provide New Hires

Part 2: ***Clean the Mess***

- Set Montana's Public Pension Systems on a Closed Amortization Schedule

Part 3: ***Build in Preventative Measures***

- De-risk Current Actuarial Assumptions and Set a Closed Payment Schedule for Future Unfunded Liabilities

Part 4: ***Plan for the Future***

- Routinely Stress Plans to Identify Trends and Set Automatic Adjustments

Questions?

Pension Integrity Project at Reason Foundation

Steven Gassenberger, Policy Analyst
steven.gassenberger@reason.org

Leonard Gilroy, Senior Managing Director
leonard.gilroy@reason.org