

Retirement 101- Defined Benefit Plans

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Focus Today:

- Retirement 101—A Defined Benefit (DB) View
- DB Plans—status in private sector vs. public sector
- DB Plans—likely reforms
- DB Plans—alternatives to CalPERS or 1937 Act plans

DB Plans—Private Sector vs. Public Sector

- **Private Sector**

- Until 1978, private sector retirement consisted primarily of Social Security and company sponsored defined benefit plans
- 401(k) plans authorized by Congress in 1978, set in motion a revolution in private sector retirement plans
- Number of defined benefit plans in private sector peaked in mid-1980's at 112,000. The number of plans today stands at 30,000¹

¹ PBGC – An Analysis of Frozen Defined Benefit Plans (December 2005)

DB Plans—Private Sector vs. Public Sector

• **Private Sector (con't)**

- From 1986 to 2004, 101,000 single-employer plans were terminated with approximately 7.5 million participants¹
- In 1985, there were about 22 million active employees in single-employer private sector plans; by 2002 that number was 17 million¹
- In fall of 2003, an AON study of 1,000 private sector plans found that 15% of the plans were frozen to one degree or another and that another 6% were considering freezing their plans¹

¹ PBGC – An Analysis of Frozen Defined Benefit Plans (December 2005)

DB Plans—Private Sector vs. Public Sector

- **Private Sector (con't)**

- Recently more press coverage of plan freezes in private sector, airlines bankruptcies and troubles at the PBGC, have raised further concerns about the safety and security of defined benefit plans in private sector
- Recent conferences sponsored by the International Business Forum in San Francisco raised some interesting perspectives on 401(k) plans by some of their pioneers, who at the time championed them as the replacement of the DB plans

DB Plans—Private Sector vs. Public Sector

- **Private Sector (con't)**

- 3 of 4 55-64 year olds have less than \$60K saved
- Survey on Retirement Confidence by Employer Benefits Research Institute in 2005 found:
 - 32% are a lot behind in saving
 - 23% are a little behind in saving
 - 38% feel they're on track
 - 7% are ahead of schedule

DB Plans—Private Sector vs. Public Sector

- **Private Sector (con't)**

- Employer Benefit Research Institute found 50% of 401(k) participants have either no equities or more than 90% of their portfolio in equity
- Hewitt Associates study found 33% of 401(k) participants invest in either one or two asset classes
- Profit Sharing Council of America found 60% never rebalance their portfolio after initial enrollment

DB Plans—Private Sector vs. Public Sector

- **Private Sector (con't)**

- In Summary, while the number of DB plans are declining and the number of plan freezes are growing, there are major concerns among employers, investment providers and Human Resources personnel that DC plans have been oversold. The effects of the loss of defined benefit plans will be felt over the next 20 years as the “baby boom” generation retires on less replacement income than their parents.

DB Plans—Private Sector vs. Public Sector

- **Public Sector**

- In 1935, initially the public sector was not eligible for the newly enacted Social Security.
- Public DB pension programs were established by states, counties (1937 Act in CA), and cities
- CalPERS founded in 1932
- 1951—state and local governments eligible for Social Security participation—today only 6 states do not participate in Social Security

DB Plans—Private Sector vs. Public Sector

- **Public Sector (con't)**

- DB plans today are a key piece of government employee benefit packages. Initially retirement benefits were viewed as a reward for long career of service at lower wages than private sector counterparts. Today, many private sector employees view higher pensions as excessive in their diminishing DB/401(k) world.
- In the past 20 years as private DB plans have declined and been frozen, California public pension plans have seen younger retirement ages, higher benefit formulas and almost universal use of single-highest year as the final wage base.

DB Plans—Private Sector vs. Public Sector

- **Public Sector (con't)**

- The past 6 years in California, over 130 cities have enhanced to one of the new benefit formulas 2.5% @ 55, 2.7% @ 55, or 3% @ 60 while nearly all safety agencies have moved to either 3% @ 55 or 3% @ 50
- So what's ahead?

DB Plans—Likely Reforms

- Next 10 years will be very telling for government DB plans
- Merging factors of aging workforce, higher retirement rates, higher benefit formulas and younger retirement ages all combine to pressure all parties to reduce the costs of public DB plans
- Couple the increasing costs of pensions with the mandate of GASB 45 for other post employment benefits, most prominently retiree health care and the push for reform will loom large

DB Plans—Likely Reforms

- As an example, in 2003 Oregon State Legislature enacted reforms to pension benefits for public employees. However, courts overturned a portion of reforms.
- In Colorado there are proposed reforms by the State PERA where new hires, after 1/1/07, have a new formula that is 16% lower than current formula. Even the Governor is promoting reforms that require active employees to shift 1% of raises over the next 3 years to PERA in order to reinforce reform plans.

DB Plans—Likely Reforms

- Pennsylvania, in 2001 Legislature, increased school retirement benefits by 25% and now employer rates are slated to rise from 1.94% in 2001 to over 20% in the next decade. Reforms loom on horizon to reign in costs.
- In Illinois, State Pension Systems had \$58 billion in assets in 2004 and \$97 billion in liabilities—a 60% funded ratio. Legislature passed a reform plan to increase rates between 2005 to 2045. Today, contributions are \$1.45 billion, costs in 2010 will be \$3.4 billion. Problem, the state skipped the 2005 contribution of \$1.3 billion, leaving a continued unfunded liability.

DB Plans—Likely Reforms

- Likely reforms across the country and in California:
 - Reduce benefit formulas for new hires
 - Reduce COLAs for retirees
 - Increase years to vest
 - Older ages for full retirement
 - Elimination of single-highest-year for final pay
 - Increase in defined contribution plans for new hires

DB Plans—Alternatives to CalPERS or 1937 Act Plans

- With reform all but inevitable, what can local governments do today?
 - Examine alternatives to reduce long-term DB plan costs
 - CalPERS has enacted various reforms to assist employers including:
 - New smoothing techniques on actuarial gains/losses
 - New reduced formula options for new hires
 - Adoption of local pension plans for current and/or new hires providing benefits that are lower in cost through creative plan design including:
 - Greater cost sharing between employer/employee
 - Longer vesting periods at local agency rather than among multiple agencies
 - Older ages to begin drawing benefits