LEGISLATIVE PROGRAM REVIEW AND INVESTIGATIONS COMMITTEE

Date: April 17, 2015

To: Senator John Fonfara
Representative Christie Carpino
PRI Co-Chairs

From: Scott Simoneau
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PRI Staff

Re: Possible PRI Study of Establishing a 401K-Like Plan for State Employees

The PRI committee voted on February 11, 2015, to direct its staff to look into the feasibility of studying four different topics, and possibly drafting study scopes for each. One of these topics was the feasibility of establishing a 401-K-like retirement plan (i.e., defined contribution (DC)) for new state employees.

This memo considers the usefulness of PRI conducting a study of the feasibility of establishing a defined contribution retirement plan in Connecticut, for the purpose of either reducing the state's current unfunded accrued pension debt of $15 billion or otherwise saving money. To be clear, state employee retirement funding is a highly complex area, based on actuarially-developed probabilities of employee characteristics, assumptions about investment returns, and reliance on government pre-paying for something far in the future. This memo – with its brief background descriptions and more specific information via a series of questions and answers -- offers a broad overview of this complicated area but cannot possibly cover all contingencies. Based on this preliminary work, however, PRI staff makes these observations relevant to the usefulness of a PRI study at this time:

- No new retirement plan, including one based on defined contributions (i.e., 401K-like), could be established for state employees until the expiration of the 2022 SEBAC agreement, unless SEBAC agreed to reopen the agreement.
- Establishing a defined contribution retirement plan for new state employees would not reduce the existing unfunded pension liability.
- Assuming a new defined contribution plan would provide equivalent benefits to those of the current plan, the new DC plan likely would not reduce the annual current plan costs for current workers' future benefits.

Finally, the study would likely require the services of an actuary to calculate the true impact of enrolling new employees in a defined contribution program and any associated effects on the current defined benefit plan.

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Background

Connecticut State Employee Collective Bargaining and Retirement Benefits

State employees through their bargaining units have had the authority under state law to collectively bargain on wages, hours, and other conditions of employment since 1977. The State Employee Retirement Act was amended in 1981 making state employee retirement benefits a mandatory subject of collective bargaining, and required state employees to be represented by a coalition of all the bargaining units, the State Employees' Bargaining Agent Coalition (SEBAC). The first pension agreement was collectively bargained between the state and the employee coalition in 1982 and has been modified by seven subsequent agreements, the most recent the 2011 SEBAC agreement, which expires in 2022.

Despite the collective bargaining agreement authority between the state and its employees, any agreement, including a retirement benefits contract, must be filed with the legislature for approval or rejection by majority vote or for de facto approval by inaction after a certain amount of time. If any new agreement provisions conflict with state statute or regulation, approval of those conflicts must be specifically requested (C.G.S. Sec. 5-278(b)). During the time an agreement is in force, the legislature cannot change any of the contract terms, even by legislation (C.G.S. Sec. 5-278(e)). The current SEBAC retirement benefits agreement governs all current and future employees and is in place until a subsequent agreement is negotiated and approved.

Types of Employer Retirement Plans: Defined Benefit or Defined Contribution

The two main types of employer retirement plans are defined benefit (DB) and defined contribution (DC) plans. A defined benefit plan like SERS provides a fixed benefit, known as a pension, at retirement, determined by years of service and salary. The employer funds the plan, to which employees may or may not also contribute.

In contrast, a defined contribution plan, such as a 401K, does not pay a fixed benefit; the income available from such a plan is based on the actual balance accrued at retirement in an individual tax-deferred account. Both DB and DC plans typically include annual contributions from employer and employee. The major difference between the two types of plans is that investment risk is assumed by the employer in DB plans, because a fixed benefit must be paid no matter what, while this risk is shifted to the employee in DC plans.

Questions Pertinent to Consideration of Defined Contribution Plan for New State Employees

I. **How Is SERS currently funded?**

a. SERS is statutorily required to be funded on an actuarial reserve basis.

i. The state makes an annual contribution to the SERS fund, based on an actuarial valuation (e.g., averaged expectations about employee life span, years on job, and salary) prepared at least every two years to determine what dollar amount will ensure the fund will meet future payment obligations. (See Table 1)

b. The state's annual contribution to the SERS fund is composed of two parts: 1) normal cost and 2) unfunded accrued pension liability amortization payment.

i. **Normal cost** is the amount of the money the state needs to reserve in the current fiscal year for employees currently working in that year (i.e., current service), based on actuarial calculations of what the future costs of those workers' retirement benefits will be.

1. Employee contributions lower the normal cost the state pays.[1]

ii. **Unfunded pension liability amortization payment** is the annual amount of money that is calculated to pay off the unfunded liability (totaling $15 billion – Table 4) over 30 years. According to this schedule, the unfunded liability should be eliminated by 2031. (See Table 3)

1. The unfunded liability is the bill for past years' liabilities that were not funded when accrued.

2. Who accounts for this unfunded accrued liability? (See Figure 1)

a. Retirees and beneficiaries account for 70 percent of the unfunded liability

b. Active employees account for 29 percent

c. Inactive members with vested benefits account for 1 percent

[1] The annual normal cost and employee contributions combined equal the "present value" of the funds needed in the future to pay out the actuarially established retirement benefits of those current employees.

II. **What impact could the implementation of a defined contribution (401K- type) plan for new employees have on Connecticut's unfunded accrued pension liability for the State Employees Retirement System (SERS)?**

a. Changing to a 401K-like plan for new state employees would not reduce this liability because the liability is attributed to retirees and current employees. (See Table 4) Newly hired employees do not start with any unfunded liability and, if their normal cost is fully funded each year, should not accrue an unfunded liability.

b. Generally speaking, closing a defined benefit plan to new members can increase DB plan costs due to several factors:

    i. Shift to lower-return investments

        1. A DB plan with a mix of young, middle-aged, and older workers allows for a diverse investment portfolio. In contrast, a closed DB plan with no new younger members must shift away from higher return/higher risk to more conservative investments.

        2. Decreasing contributions to the plan relative to increasing payouts increases the need for more liquid assets.

            a. This creates a need to shift assets to investments with more predictable cash flows. This generally has a negative impact on the fund and results in lower investment income.

        3. Decreased investment returns require higher employer and/or employee contributions

            a. Investment returns make up largest portion of pension plan revenue.

                i. For a typical career employee, more than one-half of the investment income earned on assets accumulated to pay benefits is received after the employee retires.

    ii. Loss of contributions from new members

        1. New SERS members contribute beginning with their first paycheck, but are not vested (i.e., eligible for a benefit at

retirement) for five years. Many will leave state service before vesting and therefore forfeit these contributions.

iii. Any unfunded liability must be spread across a shrinking payroll base and could change the amortization schedule to require larger payments earlier

1. Government accounting standards (GASB 25 and 27) require that the DB unfunded liability be amortized as a level percent of the projected payroll or as level dollar amounts.

2. For an open DB plan, payrolls can be expected to grow as new workers replace retiring employees and average pay generally increases. As a result, payment schedules can increase at the same rate as payroll.

3. However, once a DB plan is frozen, payroll will decline over time. Therefore, a frozen plan must be amortized over a decreasing payroll, as opposed to an open plan that can spread the costs over a growing payroll base.

iv. Administrative costs are not eliminated for DB plan.

1. The plan must be administered until the last participant retires.

III. **What are some of the implications of offering a defined contribution plan for the state's annual normal cost contributions? (i.e., cost of current employees' future benefits)**

a. There are many ways in which a defined contribution plan can be structured but, for the purposes of this discussion, we have assumed that any analysis of, or comparison between, defined benefit and defined contribution plans would be for *equivalent benefits*.

b. In general, providing *equivalent benefits* under a defined benefit structure may be less expensive to the individual under a defined contribution plan due to:

i. Longevity risk pooling

1. In a DB plan, only enough assets are required to pay for the average life expectancy. In a DC plan, the individual must guess his or her exact life span or accumulate more assets to last a maximum life expectancy.

ii. Maintaining a more balanced portfolio over longer period of time

iii. Achieving higher investment returns due to diverse investments, professional management, and lower fees

1. There is an additional cost to manage a DC plan that is usually higher than a DB plan because administrative costs are driven by scale.

    a. In addition, in the first year of a DC plan, there can be significant start-up costs.

c. The state's normal cost contribution (for current employees' service) for newest non-hazardous Tier III employees is the lowest among all the SERS pension plans at 2.57percent of salary. The state could potentially save some money if it established a 401K plan that features a contribution that is less than 2.57 percent (Table 2). Employees may have to contribute more to obtain equivalent benefits, however.

d. A DC plan usually has an employer contribution; most also match.

i. According to the Plan Sponsor Council of America (PSCA), a national, non-profit industry association, companies contributed an average of 4.7 percent of pay to a DC plan in 2013 (up from 4.5 percent in 2012 and 4.1 percent five years ago) and 80.1 percent of such plans make a match on employee contributions.

ii. (The state's contribution rate for the Alternate Retirement Plan, a DC plan for employees of the state's colleges and universities, is 8 percent. Employees contribute 5 percent.)

IV. **Does the governor's proposed budget reflect fully funding the state's actuarially determined annual contribution to SERS in FY 16 and FY 17?**

a. Yes. The state's total SERS contribution is calculated to be $1.514 billion in FY 16 and $1.569 in FY 17. The governor's proposed budget appropriates $1.220 billion in FY 16 and $1.255 in FY 17 to fully fund the General and Special Transportation funds' portions of the SERS contribution. The balance of the contribution is made up of recoveries from other appropriated fund agencies as well as federal recoveries, which are approximately $294 million in FY 16 and $314 million in FY 17.

V. **Have any recent changes been made to SERS and retired and active employee health benefits to generate savings and reduce the state's long-term liabilities?**

a. The 2011 SEBAC agreement made numerous changes to SERS, retiree health insurance, and health benefits offered to active state employees. Changes are briefly summarized below.

i. SERS

1. Pension changes included establishing a new benefit tier – Tier III – for new employees as of FY 12; increasing the normal retirement age by three years; increasing hazardous duty years of service from 20 to 25 years; increasing the early retirement penalty from 3 percent per year to 6 percent per year; imposing new caps on salary as well as mandatory overtime used in pension calculations; changing minimum and maximum cost of living adjustments (COLA) to 2 percent and to 7.5 percent; requiring a recalculation of the "breakpoint" used to determine pension amounts; and creating a new hybrid pension plan for employees eligible to join the state's defined contribution Alternative Retirement Plan (ARP).

ii. Retiree Healthcare

1. The agreement made several changes intended to reduce state expenditures for retiree healthcare coverage by increasing service and age eligibility requirements, increasing contributions by employees and the state to the retiree healthcare trust fund, and by increasing retiree premiums under certain circumstances.

iii. Employee Healthcare

1. The 2011 agreement created a new Health Enhancement Program (HEP) in the hope that increasing disease prevention and early intervention services will decrease long term expenses. It also made several changes to prescription drug copayments and increased participation in a mail-order pharmacy program. In addition, the agreement created a new emergency room visit copay to discourage unnecessary ER visits.

VI. **Preliminarily, what have been some of the past experiences of other state and local governments that have made a switch to a defined contribution or other system?**

a. Case studies of three states that made the switch from defined benefit to defined contribution plans – West Virginia (1991), Michigan (1997), and Alaska (2005) – show they experienced exacerbated underfunding problems (decreasing solvency) and increased annual costs (decreasing liquidity).

b. In 2005, West Virginia switched back to the DB plan.

c. In addition, employees under the new defined contribution plans found it difficult to retire due to inadequate account balances. For instance, in Michigan, average retirement income was approximately $8,200/year for DC plan participants vs. over $20,000/year for DB plan members.

d. In 2012, Kansas, Louisiana, and Virginia replaced defined benefit plans with cash balance or hybrid plans for new employees. A cash balance plan is a pension plan under which an employer credits a participant's account with a set percentage of his or her yearly compensation plus interest charges. A hybrid plan has elements of both a DB and DC plan. (See Rhode Island example below.)

VII. **More recently, what pension reforms have been enacted in Rhode Island?**

a. In 2011, Rhode Island passed a comprehensive pension overhaul called the Rhode Island Retirement Security Act of 2011 (RIRSA). This new law has been implemented but is being challenged in the Rhode Island Superior Court by current and retired state employees. Recent reports indicate that the unions and the state may have developed a settlement agreement to avoid a trial set to begin April 20.

b. RIRSA includes four major parts:

    i. A new defined - contribution plan to work in tandem with the current defined - benefit pension plan (referred to as a hybrid plan). State employees contribute 3.75 percent toward a defined benefit plan and 5 percent toward a defined contribution plan. (This is the same total amount (8.75 percent) state employees contributed under the old defined benefit plan.) The state will contribute an additional 1 percent to the defined contribution account;

ii. A suspension of cost-of-living adjustments for all current retirees until the pension system reaches a combined 80 percent funding level;

iii. An increase in the retirement age for current employees that matches Social Security thresholds, with provisions that accommodate those eligible to retire or close to retirement; and

iv. A change in the amortization of liabilities. The legislation increases the amortization schedule by six years, from 19 to 25 years.

Table 1. Most Of The State's Current Contribution To SERS Is For Past Unfunded Pension Liabilities (FY 16)		
Contribution for	Contribution Amount	Contribution Rate
A. Normal Cost: Service retirement benefits Disability benefits Survivor benefits Total Normal Cost	$349,193,1 25 2,264,3 78 4,476,874	10.01% 0.06% 0.13% 10.20%
B. Less Member Contributions	$355,934,377	(2.21)%
C. Employer Normal Cost	$278,812,817	7.99%
D. Unfunded Actuarial Accrued Liabilities (based on 17 years at level percent of payroll amortization)	$1,235,654,507	35.43%
E. Total (C. + D.)	$1,514,467,324	43.42%

1. The current total SERS unfunded accrued pension liability is about $15 billion.

- o The FY 16 amortized payment toward that liability is set to be about 1.2 billion (Row D).
- o Row C shows the normal cost to the state to fund current active members of SERS of about $280 million, for FY 16.

2. The state's total SERS contribution for FY 16 is calculated to be $1.514 billion (Row E). The governor's proposed budget appropriates $1.220 billion in FY 16 to fully fund the General and Special Transportation funds' portions of the SERS contribution. The balance of the contribution is made up of recoveries from other appropriated fund agencies as well as federal recoveries, which is approximately $294 million.

Table 2. The Normal Cost Contribution Rate The State Pays Is The Least For New Employees (Tier III- Other) (FY 16)

Group	Normal Cost	Normal Rate
Tier I – Hazardous	$ 0	0.00%
Tier I – Plan B	26,922,471	13.79
Tier I – Plan C	630,363	9.99
Tier II – Hazardous	34,043,681	13.94
Tier II – Others	95,233,886	9.31
Tier IIA – Hazardous	47,280,250	10.22
Tier IIA – Others	57,438,383	5.24
Tier III – Hazardous	3,392,664	4.14
Tier III – Hybrid Plan	7,343,290	6.30
Tier III – Others	6,527,829	2.57
Total	$ 278,812,817	7.99%

- The average normal cost contribution rate is nearly 8.00 percent of payroll, but the rate for new employees is the least at 2.57 percent; the most is for Tier II Hazardous at 13.94 percent.

Table 3. There Is A Schedule To Eliminate The Unfunded Accrued Liability Over 17 Years			
Valuation Year	Unfunded Accrued Liability ($ in thousands)	Amortization Period	Amortization Payment ($ in thousands)
2014	$14,920,815	17	$1,235,655
2015	14,831,633	16	1,281,918
2016	14,763,050	15	1,336,769
2017	14,461,621	14	1,377,793
2018	14,120,903	13	1,422,590
2019	13,844,071	12	1,483,377
2020	13,499,487	11	1,548,974
2021	13,065,151	10	1,618,553
2022	12,528,921	9	1,692,461
2023	11,878,546	8	1,771,323
2024	11,100,434	7	1,856,032
2025	10,179,261	6	1,947,913
2026	9,097,547	5	2,049,092
2027	7,835,042	4	2,163,381
2028	6,367,663	3	2,298,777
2029	4,665,447	2	2,477,019
2030	2,687,721	1	2,797,821
2031	0		

Figure 1. % Actuarial Accrued Liability by Group

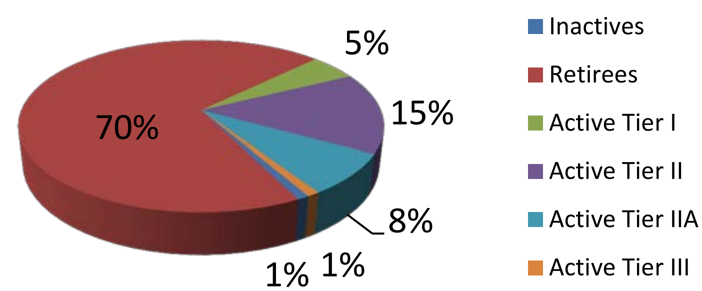

Table 4.

	JUNE 30, 2014	JUNE 30, 2012
1. ACTUARIAL ACCRUED LIABILITY		
Present value of prospective benefits payable in respect of:		
(a) Present active members		
- Tier I – Hazardous Duty	$ 49,210,224	$ 66,444,936
- Tier I – Plan B	1,173,883,113	1,343,050,284
- Tier I – Plan C	37,753,401	50,902,606
- Tier II – Hazardous Duty	1,188,010,935	1,246,123,225
- Tier II – All Others	2,715,215,560	2,316,784,672
- Tier IIA – Hazardous Duty	912,871,620	590,337,378
- Tier IIA – All Others	1,057,034,112	756,291,436
- Tier III – Hazardous Duty	9,671,840	431,199
- Tier III – Hybrid Plan	204,950,079	0
- Tier III – All Others	27,212,681	1,598,975
- Total actives	$ 7,375,813,565	$ 6,371,964,711
(b) Present inactive members and members entitled to deferred vested benefits:	225,853,075	235,055,761
(c) Present annuitants and beneficiaries	17,903,943,137	16,411,731,262
(d) Total actuarial accrued liability [1(a) + 1(b) + 1(c)]	$ 25,505,609,777	$ 23,018,751,734
2. ACTUARIAL VALUE OF ASSETS	$ 10,584,795,257	$ 9,744,985,549
3. UNFUNDED ACTUARIAL ACCRUED LIABILITY [1(d) – 2]	$ 14,920,814,520	$ 13,273,766,185