Retirement Plan Design Study

Executive Summary

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Minnesota Statewide Retirement Systems

Retirement Plan Design Study

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Study purpose

2010 Legislation required the three statewide retirement plans to complete a benefit design study. This study analyzes alternative retirement plan designs including defined benefit, defined contribution, and hybrid plans, comparing features such as overall plan design, costs, portability, income security/adequacy, investment performance, and recruitment and retention. This study provides actuarial analysis of the costs associated with transitioning from the current defined benefit (DB) structure to a defined contribution (DC) plan. The intent is to illustrate the proponent and opponent views of design options and does not make plan design recommendations.

Study contents

While reviewing the various options, the study provides membership, funding history , and statistical data on the three largest retirement plans; specifically, the Minnesota State Retirement System (MSRS) General Plan, the Public Employees Retirement Association (PERA) General Plan and the Teachers Retirement Association (TRA). In addition, information regarding the Minnesota State Board of Investment (SBI) investment policy, standards, and performance are summarized. As the organization responsible for managing the retirement plan assets of the statewide retirement plans, SBI has a reputation for a financially successful, long-term investment program.

Minnesota, disciplined and proactive

Clearly, the 2008-2009 economic downturn adversely impacted the overall funding of public pension plans throughout the country. Minnesota responded quickly to the decline in funding with a "sustainability" package during the 2010 Legislative Session that modified future benefits for all members—active, retired, and deferred. Historically, Minnesota has been disciplined to properly fund and manage pension liabilities in an effort to prevent long-term adverse impacts. This recent legislation is a continuing example of the bi-partisan, long-term, responsible approach that the state's legislators and governors have modeled to maintain the financial security of Minnesota's public pension plans. Both taxpayers and workers have a vested interest to ensure that public pension plans are funded appropriately and are sustainable for the future.

Retirement crisis looms

Overall, retirement plans -- public pensions, private pensions, and personal retirement savings—have been impacted by these severe economic conditions. Americans are facing a retirement crisis, mainly due to the dwindling pension coverage provided by the private sector. This crisis should be of concern for all citizens, the communities in which they live, as well as, state and federal governments. Without adequate retirement income, retirees may not be able to afford basic living expenses, pay for health care or taxes, purchase goods and services, and remain a vital, contributing part of their communities. Taxpayers and workers have much at stake in this retirement crisis because without adequate retirement income, there is an increased risk of higher elder poverty and rising public assistance costs over the long-term.

Key Findings – Costs

- ***Transition costs high.*** According to actuarial analysis completed by Mercer, there are high costs to transitioning from the existing DB to a DC for new hires. Mercer analyzed the cost of closing the current DB plans and placing new hires in a DC plan with a 5 percent employer and 5 percent employee contribution rate. The costs to transition to this new DC structure would be approximately $2.76 billion over the next decade for all three systems. The costs are detailed in the table below. Costs increase during a transition period because once a plan is closed to new members any unfunded liabilities remaining in the existing DB plan must be paid off over a shorter timeframe. This is very similar to what the Minnesota Legislature faced recently in funding the costs of the Minneapolis Employees Retirement Fund (MERF), which was closed to new members in 1978.

Change in Total Required Contributions ($millions)

Years	PERA	TRA	MSRS	Total
1-5	$573	$653	$276	$1,502
6-10	$529	$433	$298	$1,260
11-15	$302	($57)	$238	$483
16-20	$58	($610)	$161	($391)

- ***Mid-term costs lower***. While there are significant transition costs in the next two decades, paying off the unfunded liability of the existing DB plans in a shorter timeframe would eventually lower future costs in the mid-term (11-20 years), because the accelerated funding has the opportunity to generate investment earnings. For example, savings start to accumulate after year 12 for TRA and after year 19 for PERA.

- ***Long-term costs higher.*** Once the unfunded liability of the existing DB is fully paid off, however, there are no longer savings. For the long-term, the Mercer analysis shows that the ongoing "normal cost" of the existing DB plans is less than the cost of a future replacement DC plan that has a contribution structure of 5 percent employer and 5 percent employee as modeled in this study.

- ***Transition costs findings similar to other states.*** Mercer's analysis regarding transition costs is consistent with similar studies recently conducted in other states such as Nevada, Kansas, Rhode Island, New Mexico, and Missouri. Due to the costs of multiple actuarial studies, the analysis in this study is limited to one DC design, which is similar in structure to a Senate amendment offered last year to the 2010 pension reform bill. That amendment would have placed all newly-hired employees in a DC plan with a 5 percent employee and 6 percent employer contribution rate. For this study, Mercer analyzed a lower-cost DC plan of 5 percent employee and 5 percent employer contribution rates. The Legislative Commission on Pensions and Retirement (LCPR) may wish to explore additional options for analysis.

- ***More conservative investments required.*** Relative to an open ongoing DB plan, a closed DB requires higher cash outflow, meaning benefit payouts are high relative to contribution revenue. As a result, plan assets will be spent down and thus, must be invested in a lower risk investment allocation. The financial impact of these investment allocation changes would be significant and are not included in the cost estimates. Mercer estimates that if the investment earnings and interest assumption for the closed DB were lowered from 8.5 percent to 6 percent to reflect a more conservative asset allocation, the actuarial accrued liabilities would increase by approximately 30 to 40 percent and the unfunded actuarial accrued liabilities would more than double.

Key Findings – Plan Design Comparison

The study has a comprehensive overview of both proponent and opponent views of defined benefit, defined contribution and hybrid plans. Several examples of alternative benefit designs utilized by other state retirement systems are also described in each section. The key arguments regarding these plan designs can be summed up as follows:

- DBs run the risk of having unfunded liabilities and less predictable costs that can negatively impact government budgets and redirect funds away from public services; alternatively, DCs run the risk of providing inadequately funded retirement incomes that may lead to higher public assistance costs.

- DCs grant the individual employee more control over investments, but individuals usually incur higher investment fees and lower returns relative to DBs.

- DCs can be more attractive and beneficial to younger, mobile employees, but recent surveys show DBs are gaining in popularity as employees have become more aware of investment risks.

- While the short-term costs to transition from a DB to a DC are high, a DC can provide the opportunity to lower government costs over the longer term depending on the contribution rate level established.

- DBs can provide the same level of income at roughly half the costs of a DC plan due to DB's superior investment returns and the ability to pool longevity risk. DC plans, however, are more flexible for the employer, allowing the employer to scale back contributions/benefits during difficult economic times.

- Hybrid plans spread the risk between the employees and employers while mitigating but not eliminating unfunded liabilities and longevity risk.

Study Recommendations

The three retirement systems recommend that the Legislative Commission on Pensions and Retirement (LCPR):

- Carefully analyze the financial impacts of transitioning to an alternative plan structure. Modifying plan design in the future can have complex financial implications with unintended consequences. The LCPR should review the appropriate plan design and clearly understand the funding requirements of any changes. If changes are made, the LCPR should develop a specific, long-term funding strategy that identifies sources of revenue and future costs which should be in place prior to implementing any changes.

- Consider the potential negative effect that closing the DB will have on future investment returns. It is probable that SBI's investment strategy would need to become more conservative if the existing DB plans are closed, thereby lowering expected future returns.

- Analyze benefit adequacy and the impact that decisions regarding plan design have on Minnesota public employees, retirees, state and local governments, and the state and local economies.