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MEMORANDUM

TO: City Council, City of North Miami Beach

FROM: Robert D. Klausner, Esquire 

RE: Defined Benefit - Defined Contribution Debate

DATE: January 3, 2011

Purpose:

The objective of this memorandum is to summarize the issues raised across the country relating to the structure of public sector retirement systems. As a part of that process, this memo reviews the academic literature comparing Defined Benefit (DB) plans with Defined Contribution (DC) plans and to provide a summary on the implications of moving from a defined benefit plan to a defined contribution plan. Emerging trends over the past decade will also be discussed.

This memorandum will focus on the advantages and disadvantages of both DB and DC approaches and will set forth both practical considerations and theoretical arguments. As will be illustrated below, the evaluation of an advantage/disadvantage can vary depending on one's philosophical, political, employment, or fiscal outlook. The advantage for one plan usually results in a corresponding disadvantage for the other plan, depending on one's perspective. In the final analysis, the author believes that maintenance of the current defined benefit system is the optimum means of providing a meaningful retirement to valued public employees and represents the most effective tool to insure a stable, well-trained, dedicated municipal workforce.

The economic downturn which began in 2007 and is now commonly referred to as the "Great Recession" serves to emphasize the need to maintain the current retirement program as the only meaningful way to ensure a stable city workforce while also providing essential protection for the men and women who have been asked to dedicate a lifetime of service for the benefit of the public.

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Executive Summary:

There are two broad categories of retirement plans. Each presents relative advantages and corresponding disadvantages. There is no single best solution for all situations. Rather, each feature of both types of plans should be evaluated in the context of the specific plan objective(s). While there is no single best plan design for all employees or employers, the author has concluded that for the welfare of our cities and states and the public employees they employ, the maintenance of the current defined benefit retirement model is the best alternative. Abandonment or radical curtailment of the defined benefit retirement program is directly contrary to sound governmental employment practices.

Substitution of a defined contribution plan would exacerbate current economic burdens. Constitutional requirements mandate the maintenance of the defined benefit program for current employees. Closure of those plans would dramatically increase the cost of maintaining benefits for the current workforce and the retiree population. At the same time, the switch to a DC plan for new employees would create new recruitment challenges, even in this difficult labor market. Exposing employees to market risks and denying them adequate death and disability protection is a direct disincentive to public employees taking the risks necessary on a daily basis to preserve life and property.

The Analysis

Defined benefit plans pay guaranteed monthly retirement benefits based on a fixed/defined formula. Generally, benefits are calculated based on a specified accrual rate per year of service. DB plans are actuarially funded by the plan sponsor taking into account actuarial experience which will vary from year to year. As a result, employer contribution and funding requirements will fluctuate from year to year. Employers bear the investment risk, but DB plans provide stable lifetime monthly retirement income for retirees. DB plans also have the possibility, through good investment return, to pay for themselves over time.

In contrast, defined contribution plans specify the employer contribution rather than any particular monthly income at retirement. Employer contributions are limited to a specified percentage of payroll/employee earnings. DC plans do not guarantee any specified benefit at retirement, other than the accumulated balance of employer and employee contributions, plus investment earnings. DC plans typically provide a lump sum account balance at retirement. Unlike a DB plan, in a DC plan the employee bears the investment risk. The eventual DC benefit is dependent on the amount of accumulated assets and the number of years that the retiree draws down the account balance.

Simplified even further, in a DB plan the employer assumes the investment and mortality risk. In a DC plan, the employee bears these risks. Arguably the strongest advantage of DC plans is the contribution stability they provide for employers and the portability offered to employees. Arguably, the strongest advantage of DB plans is guaranteed retirement income which is made available by the economies of scale and actuarial funding of DB plans.

Approximately ninety percent of state and local government employees participate in DB plans as their primary retirement benefit. DC plans serve as the primary plans for the remaining ten percent. Texas employs a cash balance plan for more than 1000 of its municipal and county governments. That program uses both elements of defined benefit and defined contribution plans. The features which compare to the North Miami Beach plan require a comparable contribution.

The debate between the proponents of DB plans and DC plans is fueled in large part by concerns over shrinking tax revenues brought about by tax reform legislation and the current economic conditions. The federal Pension Protection Act of 2006 has focused attention on retirement security and savings. Over the past ten years, several statewide retirement systems have switched from DB to DC for new employees, or added separate DC options. Yet, at the same time, examples can be found of closed statewide DB plans being reopened, as well as the creation of hybrid plans established alongside existing DC plans. Since 2001, eligible state and local employees in Florida, Ohio, South Carolina, Montana, and Colorado now have the option of choosing between a DB and a DC plan. Participation in those elective programs remains relatively low and they are favored most frequently by professional workers with relatively short tenure. Torrington, Connecticut recently began a process of placing new hires in DC plans. The City of Ft. Lauderdale has a DC plan for its new non-public safety employees. Other cities have created voluntary DC alternatives.

In the corporate, private sector environment, a clear trend of DB plan closings has emerged. It is unclear whether or not this trend will similarly play out in the public sector. To the extent that a trend can be identified in the public sector, DC alternatives are being created within and alongside existing DB plans. When given the choice, public employees have selected DB plans by wide margins over DC plans. Other options include DB plan terminations, creating tiered DB plans for new employees, lowering DB accrual rates for future service, and establishing hybrid/cash balance plans.

The following chart, which is a compilation of all of the sources used and cited in the footnotes in this report, summarizes essential characteristics and concerns of defined benefit and defined contribution plans:

DEFINED BENEFIT AND DEFINED CONTRIBUTION PLAN CHARACTERISTICS¹

Characteristics	Defined Benefit Plans	Defined Contribution Plans
Guaranteed post-retirement income	Yes	No. Annuity purchase options are expensive
Financial liability	Rests on plan sponsor; actuarially funded over a period not to exceed 30 years	Rests with participant, no actuarial liability

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Defined Benefit and Defined Contribution Plans: A History, Market Overview and Comparative Analysis, Stephen P. McCourt, Benefits & Compensation Digest, February 2006.

Investment risk	Rests on plan sponsor	Rests with participant
Responsibility placed on employee (empowerment)	Little	Significant - employee makes voluntary contributions and investment decisions
Responsibility placed on employer	Significant - investment decisions, financial liability	Little
Employer fiduciary responsibility	Significant	Significant
Investment results	On average returns are higher	On average returns are lower, but large variation results from individual investment choices
Investment Fees	Lower overall fees	Higher overall fees
Aggregate retirement savings	Significantly increases retirement savings rate with forced savings feature	Less average savings, depending on participant
Personal retirement savings	Maximizes savings for retirement	Allows withdrawals and loans before retirement, depleting retirement savings
Plan Sponsor's Administrative Fees	Generally higher fees	Generally lower depending on education, planning and service provided to employees
Administrative complexity	Generally high	Significantly lower
Flexibility	More flexible: disability, retirement incentives, outside service credit	Simple design based on employer and employee contributions
Portability	Not typical	Yes
Employee retention	Favored by longer tenured/older employees	Attracts shorter tenured/younger employees
Plan Closing	Legacy issues and continuing funding obligations are complex	Relatively simple

Background:

Defined benefit plans (DB) specify the monthly benefit that vested employees will receive upon reaching normal or early retirement eligibility. The monthly benefit is generally based on a mathematical formula utilizing a benefit accrual factor for each year of service multiplied by final average compensation earned prior to retirement. In theory, because the benefit is "defined," an employee is able to anticipate his or her monthly retirement benefit prior to retirement eligibility. As a general rule, the monthly benefit will continue for the member's

entire lifetime, regardless of the positive or negative investment performance of the underlying assets in the plan. Under Florida law, public employers are required to annually fund their DB plan on an actuarially determined basis.²

Municipal governments that maintain defined benefit plans for police officers are entitled to receive a rebate of a state tax on automobile and theft insurance policies. This tax, authorized by Florida Statutes, Chapter 185, pays a portion of the City required contribution. The tax is collected from insurance companies by the State. By meeting certain minimum benefit standards, the Town receives money under this program which otherwise would inure to the benefit of the State.

By contrast, defined contribution (DC) plans specify the employer contribution rather than a specified benefit available at retirement. For each pay period the employer contributes a certain percentage of an employee's earnings into the DC plan. DC plans do not guarantee any particular benefit at retirement, other than the accumulated balance of contributions, plus investment earnings. The final value of a retiree's accumulated DC account is not guaranteed and is generally not known until retirement.

Stated another way, in a DB plan the pension benefit is certain and the contribution necessary to fund the benefit is not. In a DC plan, the contribution is certain while the future benefit amount is not. Simplified further, in a DB plan the employer assumes the investment and longevity/mortality risk. In a DC plan, the employee bears these risks.

As a general rule, the pattern of benefit accrual over an employee's career is different between DB and DC plans. In a typical DC plan, benefits accrue at a higher rate in an employee's early years but at a lower rate compared to the later stages of the employee's career in a DB plan. This relationship explains the controversy between older and younger workers when an employer considers converting a DB plan into a Cash Balance/Hybrid plan.

Over the past several years increasing interest has been shown in corporate cash balance plans, a variation on the traditional DB plan. Cash balance retirement benefits accrue at an even, steady pace during an employee's career. For purposes of this memorandum, cash balance plans calculate benefits in a manner similar to a DC plan. For various reasons, less interest has been focused on cash balance plans and cash balance conversions in the public sector. The primary exceptions are the Texas Municipal Retirement System and the Texas District and County Retirement System. These are primarily multi-employer cash balance plans, with certain elective features mirroring traditional defined benefit plans. A clear trend has emerged in the public sector to offer both DB and DC options, permitting employee choice on which type of plan to join.

In 2008, Jacksonville created a voluntary DC plan for its non-public safety employees. In October 2010, Orange County California created a lower tier in its DB plan and allowed both current and future employees to elect participation in this plan with lower benefits, but a lower employee contribution rate. (This new elective plan is facing certain considerable scrutiny from the IRS with an uncertain result). In January 2011, the Orlando Utilities Commission will

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Section 112.64 Florida Statutes requires the amortization of plan liabilities over a period not to exceed 30 years. Shorter funding periods are required for closed plans.

replace its DC plan with a cash balance/hybrid plan, finding that the DC plan had rendered it uncompetitive in its relevant market. In December 2010, the City Council of Clearwater determined that maintenance of its DB retirement program was essential to ensure workforce stability and quality of service.

Approximately ninety percent of state and local government employees participate in DB plans as their primary retirement benefit.³ Most private sector employers provide only a DC plan, most commonly a 401(k) plan, or no retirement plan at all.⁴

The National Association of State Retirement Administrators⁵ and the National Conference on Public Employee Retirement Systems⁶ both have expressed the view that defined benefit plans should serve as the primary benefit for all public employees and should be supplemented with a voluntary defined contribution plan.⁷

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Consistent with federal law, workers who are covered by hybrid plans are deemed to be members of a DB plan, and are included in the 90% figure. *Overview of Plan Types and Their Use Among Statewide Retirement Systems*, NASRA, April 2007.

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The percentage of private sector employees participating in a DB plan decreased from 38% in 1977 to less than 20% in recent years. U.S. Bureau of Labor Statistics, *2006 National Compensation Survey: Employee Benefits in Private Industry in the United States*. The Pension Protection Act of 2006 may be accelerating this trend with corporate employers. Nationally, 47.9% of workers under age 65 participated in employer-sponsored retirement plans, both DB and DC, in 2004 down from 49.6% in 2001. *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, The Federal Reserve Bulletin, 2006.

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The National Association of State Retirement Administrators (NASRA) is a non-profit association whose members are the directors of the nation's state, territorial, and largest statewide public retirement systems. NASRA members oversee retirement systems that hold more than \$2.0 trillion in assets and that provide pension and other benefits to more than two-thirds of all state and local government employees.

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The National Conference on Public Employee Retirement Systems (NCPERS) is the largest trade association for public sector pension funds, representing more than 500 public funds throughout the United States. NCPERS members collectively oversee nearly \$3 trillion in retirement funds managed on behalf of six million retirees and 14 million active public servants.

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The NASRA resolution states that it "supports the prevailing system of retirement benefits in the public sector, namely, a defined benefit program to provide a guaranteed benefit and a voluntary defined contribution plan to serve as a means for employees to supplement their retirement savings." The Resolution further states that NASRA "supports progressive changes within this prevailing system of retirement benefits in the public sector, either within the defined benefit plan or through supplementary plans, that accommodate a changing workforce and better provide many of the features advanced by defined contribution advocates." NASRA Resolution 2003-8, August 6, 2003.

An exhaustive comparative analysis by the Arizona State Retirement System in 2006 similarly recommended this approach. According to the Arizona analysis, which was admittedly prepared by a DB plan, if the choice between DB versus DC plans is not mutually exclusive, “it appears that the most appropriate strategy may be to provide a balanced approach with a defined benefit plan as the primary income replacement vehicle and a defined contribution option such as a 457, 403(b), or Supplemental Retirement Savings Plan, to provide an additional but discretionary option for additional pre-tax retirement savings with no additional cost requirements for the employer.”⁸

This approach is in keeping with the conventional wisdom that the ideal mix of retirement income can be described as a “three-legged stool.”⁹ Under this metaphor, one leg represents Social Security; another leg represents employer-funded pensions; and the third leg is based on individual savings. Whether or not the conventional wisdom of the “three-legged stool” will need to adapt to changes in demographics, labor mobility trends, or amendments to Social Security remains to be seen.

Advantages of DB plans¹⁰:

Guaranteed Post-Retirement Income Stability: DB plans provide guaranteed monthly income during retirement. A retiree will not outlive his or her lifetime defined benefit annuity. By definition, a DB retiree who is receiving a lifetime annuity is entitled to rely on a monthly check from a properly funded plan. If the DB plan does not contain a cost-of-living (COLA) provision, the retiree who lives a long life will face the risk of inflation gradually and inevitably diminishing the purchasing power of the monthly benefit. For governmental employers that do not participate in Social Security, the financial security provided by a DB plan is particularly important.

Investment Efficiencies, Expertise, Diversification and Economies of Scale Enhance Investment Returns which Empirically are Superior for DB plans: According to the academic literature, on a per-dollar-of-benefit-paid basis, it is less expensive to provide benefits

8 *A Comparative Analysis of Defined Benefit and Defined Contribution Retirement Plans*, Arizona State Retirement System, September 22, 2006.

9 *Profitable Prudence: The Case for Public Employer Defined Benefit Plans*, Gary Anderson and Keith Brainard, Pension Resource Council, Wharton School, University of Pennsylvania, 2004.

10 *List of Advantages and Disadvantages for DB and DC Plan*, GRS Research Memorandum, Sonnanstine, Murphy and Zorn, November 17, 2003; *The Top Ten Advantages of Maintaining Defined Benefit Pensions*, NCPERS, May 2007.

through a DB plan than through a DC plan.¹¹ There are several reasons why this makes sense. DB plans employ professional money managers and consultants who are able to invest with longer time horizons and utilize asset allocation models and efficient frontier analysis based on modern portfolio theory. DC plan participants are not expected to have this degree of expertise.

Additionally, larger DB plans are generally able to invest in asset classes that are not available to DC plan participants. Private real estate, private equity, commodities, venture capital and other alternative investment strategies that are available to promote diversification and minimize risk are not realistic or readily available for the average DC plan participant.

DB plans aggregate the funds of all participants and are able to receive significant reductions in investment-related costs through their economies of scale. For this reason, total investment management fees are typically lower than in a DC plan.¹² Participants in a DC plan as a rule should invest more conservatively as they approach retirement and grow older after retirement. An active DB plan with a stable workforce is not required to alter its investment mix over time and is able to spread mortality risks over the group as a whole.

Both DB and DC plans involve administrative costs, including operating overhead, accounting, record-keeping, custody, education and information dissemination expenses. In a DB plan these services are typically provided by a combination of public employees and private contractors. In a DC plan these services are ordinarily outsourced to private firms and mutual funds. Because individual accounts and investment choice is a feature of DC plans, account information is usually updated daily and made available to the participant on a regular basis. This degree of communication, education and planning by and with DB plan participants is less important and less expensive than in a DC plan.

Total administrative and investment costs for DC plans can be more than four times higher than for similar size DB plans.¹³ Combined investment and administrative fees paid by participants in

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Defined Contribution Retirement Plan Study, prepared by GRS for the New Mexico Educational Retirement Board, 2005.

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DB investment expenses will vary with plan size and asset allocation. DC assets are ordinarily invested in mutual funds with typical expense ratios of approximately 1.25% to 1% of assets for stock mutual funds and .75% to .50% of assets for bond funds. Institutional products are available within larger DC plans. Both DB and DC plans can lower investment expenses by using index products.

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Defined Contribution Retirement Plan Study, prepared by GRS for the New Mexico Educational Retirement Board, 2005.

smaller DC plans can exceed 2% of assets and can directly and substantially impact retirement savings.¹⁴

Easier Retirement and Financial Planning Results from the Delegation of Investment Responsibilities to DB Plan Professionals and Trustees: Based on their more stable post-retirement income levels, DB plans present less complex financial and retirement planning issues for participants. Those who are not particularly interested in assuming investment responsibility are able to rely on the DB plan's expertise and dependable monthly income.¹⁵

Flexibility to Provide Disability Benefits, Early Retirement Incentives, and Recognition of Outside Service Credit: DB plans routinely provide duty and non-duty disability benefits. DC plan design does not protect participants against disability risks, but DC employers are able to separately provide disability insurance protection. In addition to disability provisions, DB plans also commonly permit the purchase of prior service credit, including military service. DB proponents would argue that the ability to purchase such service is a useful recruiting and retention tool. Early retirement incentive programs can be implemented within a DB plan, in contrast to DC plans which are less flexible for this purpose.

Advantages of DC plans:

Investment Risks Rest with the Employee Resulting in a Stable and Predictable Employer Contribution Rate: Employer contributions are easy to calculate, understand and predict based on the predetermined flat employer contribution rate set forth in the DC plan document. Unless the employer amends the plan, the employer contribution rate will remain constant and will be entirely transparent. DC contributions are not actuarially calculated and DC plans do not carry unfunded liabilities. DC proponents argue in favor of "pay-as-you-go" budgeting and spending of tax dollars.

Portability of DC Account Balances Is Desirable for Younger and Non-Career Employees: DC plans enable participants to transfer their accumulated account balance when an employee changes jobs and moves to another employer. Mobility within the U.S. workforce has increased over time and the average employee is no longer expected to work a full career with a single employer. In a DC plan, all employee contributions, and most, if not all, employer contributions

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Myths and Misconceptions of Defined Benefit and Defined Contribution Plans, National Association of State Retirement Administrators, Whitepaper, November 2002, updated February 2005, Exhibit "9". *A Comparative Analysis of Defined Benefit and Defined Contribution Retirement Plans*, Arizona State Retirement System, September 22, 2006.

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Profitable Prudence: The Case for Public Employer Defined Benefit Plans, Gary W. Anderson and Keith Brainerd, Pension Resource Council, The Wharton School, University of Pennsylvania, 2004.

(subject to vesting requirements), along with all investment earnings, may be rolled over into a new employer's qualified plan or into a rollover IRA. In the case of highly trained law enforcement personnel, pension portability often disserves the smaller employer whose officers may be lured away by advancement and other opportunities in larger agencies. The hesitation that occurs because a vested defined benefit participant is less likely to leave, a DC plan participant suffers no loss by changing employers.

By contrast, in a DB plan the non-vested employee is not entitled to any employer contributions. On balance, a younger employee who separates from service will generally be entitled to a larger distribution from a DC plan than from a DB plan. To the extent that employees fail to rollover their DC balances, the employee risks the loss of critical tax qualified retirement savings.

Inherently Simpler Plan Design and Structure Results in Lower Plan Sponsor Administrative Costs Which Can Offset Higher Investment Expenses: In contrast to DB plans, DC plans are less complicated to administer and are easier to understand. The obligation to DC participants ends when the employee terminates employment and receives their account balance. Unlike DB plans, DC plans are not required to administer benefits for terminated members and retirees.

Empowerment: DC plans rely on active participation and engagement by plan members. Many have argued that DC participants feel a greater sense of empowerment and involvement with their future financial security and retirement planning. DB plans operate independently from the members and do not require much or any employee decision-making until the member becomes eligible to retire and selects a monthly payment option. Since DC contributions are allocated directly into individual accounts, employees can identify, monitor and appreciate the contributions made on their behalf. Account information is usually updated daily and made available to the participant on a regular basis.

It should be noted that financial empowerment and employee control carries both risks and potential rewards for members who properly plan, save and invest. The corollary is that employees who fail to do so are threatened with retirement insecurity. This is particularly so in times of economic uncertainty. October 2008 was the worst single month in the history of the American capital markets with trillions in retirement savings lost in a precipitous market decline. The result for DC plan participants was to reduce available retirement benefits by 30%.

Possibility of Superior Returns and Intergenerational Transfer of Retirement Assets: If a DC participant is a skilled investor or is willing to assume greater investment risk, it is possible to achieve better than average investment returns. Regardless of the participant's investment acuity, by virtue of market cycles and timing, at least some DC investors will be able to accumulate substantial account balances. Retirees who prudently spend down their DC lump sum balance may transfer the remaining balance to their families or estate. Recent studies have shown, however, that employee directed investments perform consistently below plan wide investments directed by a Board of Trustees (See Footnote 19, *infra*).

Funding: DC administrative and investment expenses ordinarily are regularly paid on a current basis directly from the DC plan. Mutual fund and related fees are deducted out of mutual fund daily net asset values and account balances. DC plans do not carry unfunded liabilities and are easy to terminate or close. In contrast, DB plan closings present complex funding and legacy issues.

Disadvantages of DB plans:

Investment and Actuarial Risks Rest on the Employer Resulting in Fluctuating Employer Contribution Rates: DB plans are designed to pass the investment and mortality risk onto the employer, whereas DC plan structure requires the employee to assume these risks. As a result, DB employer contribution rates will fluctuate over time with actuarial experience and investment performance. If a DB plan experiences several back-to-back years of poor actuarial experience or lower than assumed investment returns, employer contributions can fluctuate dramatically.

DB plans can partially mitigate contribution rate fluctuations by using various tools including actuarial smoothing methods, adjusting and monitoring assumptions, and carefully managing asset allocations. DB plan sponsors were criticized during the 1990's for substantially reducing required minimum contributions based on unusually strong investment experience during the market bubble at the turn of the century. DB advocates have recommended adding contribution floors to maintain certain minimum employer contributions in years with consistent positive actuarial experience.

Actuarial and Structural Complexity: DB plans are funded based on actuarial experience, calculated using fairly sophisticated actuarial methodologies. DB plans utilize and are required to periodically adjust assumptions, including longevity, turnover, and investment earnings assumptions. For these and other reasons, DB plans are inherently more complex than DC plans.

Plan closure can be particularly complex for DB plans and raises various "residual plan management" issues. A closed DB plan will be required to allocate any accrued unfunded liability among the static or decreasing employee base. As a result, the normal cost component will remain the same, but an increasing amortization component will result in higher overall future contribution percentages for the remaining plan members. The decreasing member base will thus result in more volatile employer contributions.

Another issue presented by a DB plan closing is the potential employee morale and human resources considerations that may come into play. The differences between the old and new plan may be perceived as creating differential treatment issues and disparities between old versus new employees.

Less Portable and Less Advantageous for Non-Career Employees: Mobile employees who are less likely to work an entire career with a single employer will almost always receive a smaller benefit from a DB plan. Although recent federal tax amendments in 2001 and 2006 have attempted to promote portability, the fact remains that DB plans are less advantageous for short tenure employees.

Disadvantages of DC plans:

Responsibility is Placed on Employees/Retirees Who Bear the Risk of Poor Investment Performance: Not everyone has the time, resources, experience or inclination to focus on investing or retirement planning. Some individual investors in a DC plan will win, but many will not achieve index returns and will fail to rationally allocate, rebalance and spend down their DC retirement account balance. Proponents of DB plans argue that it is unreasonable to expect individual investors to outperform the professional investors who manage traditional DB pension assets. In many cases, employees who move from a DB environment to a DC plan may find they have lower benefits and potentially inadequate retirement income.¹⁶

As has become evident since 2008, many do not have the skills or inclination to make complex investment decisions and historically have been unwilling to spend much time on retirement planning. Of the group of employees who recognize the need to adequately plan and prepare for retirement, many nonetheless fail to do their homework or implement appropriate retirement plans. Evidence suggests that large percentages of short term employees who separate prior to retirement eligibility request direct lump sum distributions and do not take advantage of DC plan portability.

Lack of Guaranteed Post-Retirement Income Stability: DC plans do not guarantee any level of stable income. Retirees bear the financial risk of outliving accumulated assets. Half of all retirees will, to varying degrees, outlive the average life expectancy, in some cases by decades. The DC account balance can at best be projected prior to retirement, but will depend on market conditions, asset allocation and investment performance. A DC plan participant has the option of either adjusting their personal contribution and savings rate with investment performance or changing their post-retirement expectations and standard of living based on investment gains and losses.

To mitigate this risk, DC plans are increasingly offering the ability to purchase insurance annuities, but this option can be expensive. Empirically, few retirees have converted DC balances into guaranteed lifetime income. As recently reported, a 2007 whitepaper by Watson Wyatt Worldwide, a leading actuarial and human resources consulting firm, predicted that

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Traditional Pensions: A Tried & True System that Benefits Taxpayers, NCPERS fact sheet 1; *The Value of Defined Benefit Plans*, Issue Brief, The American Academy of Actuaries, July 2006.

employers will begin offering new low cost annuities as an investment option within DC plans. It is anticipated that the wider availability of annuity options in DC plans will serve the objective of providing greater retirement security for DC retirees.¹⁷ Watson Wyatt recommends that retirees should consider annuitizing at least a portion of their DC account balances in an effort to provide income stability for assets they need to support basic consumption needs. Watson Wyatt further recommends that the remaining DC balance can be invested more aggressively.

Watson Wyatt argues that participants are often confused about how to manage their DC lump sum balance and the difficulty of trying to stretch their assets over their lifetime. Some retirees purchase annuities on the open market, but the prices for such products are generally high and are significantly affected by interest rate fluctuations and other factors.¹⁸

At the present time, most DC retirees do not have access to annuity options in their DC plans, in contrast to all DB plans which provide lifelong monthly checks.

Individual Financial Planning Is Emphasized: DC participants are required to self direct their investment strategy with mutual funds/brokerage account options. Due to the lack of predictable retirement income if an annuity option is not available, DC plans present financial planning issues which are less relevant for DB plans. The additional focus on retirement planning inherent in a DC plan can be costly in terms of financial planning expenses and the time commitment by participants. The recent emergence of new generation life-cycle/lifestyle mutual funds may help simplify and reduce these concerns for some DC participants.

The recent United States Supreme Court decision authorizing breach of fiduciary responsibility suits based on under performance of DC accounts has created an additional level of concern. Sovereign immunity generally insulates DB board discretionary decisions because the employee has no ownership in any identifiable asset. By contrast, DC participants own their accounts and may seek a remedy for failures of employer education or inadequate investment selection options.

On Average DC Plans Generate Lower Investment Returns and Involve the Risk of Inadequate Savings: According to the academic literature, DC plan investment returns, on

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*Watson Wyatt Says Annuities Will Improve DC Plan Option, Plan Sponsor, August 6, 2007, Exhibit "12". According to Watson Wyatt's white paper, employers are now looking for more affordable annuity options and a broader range of products, including a simple, institutionally priced annuity product. This new market demand should drive supply of new annuity products to better serve the expanding DC market. *What If? Adding an Annuity to Improve Defined Contribution Plan Options*, Watson Wyatt Worldwide, June 2007.*

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What If? Adding an Annuity to Improve Defined Contribution Plan Options, Watson Wyatt Worldwide Whitepaper, June 2007.

average, are lower than DB plan returns.¹⁹ For example, a study by the actuarial firm for the Nebraska Retirement System in 2000 revealed a statistically significant difference between DB returns versus DC returns. The legislative committees studying the issue found that the DC plan did not provide adequate retirement security. From 1983-1999 the Nebraska DB plan averaged 11% and the DC plan averaged 6%.²⁰ Individual investors often react emotionally to market events and can be criticized for “chasing returns” of overvalued assets. Many investors with long time horizons are too conservative and do not adequately diversify outside of cash and fixed income investments.

As described above, DC plans are not able to offer the same diversification tools available to larger DB plans. To the extent that DC plans generally do not require the same degree of automatic forced savings as is the case with DB plans, DB plan participants are more likely to accrue adequate retirement income than DC plan participants. Recent amendments in the Pension Protection Act which permit moderate equity default allocations and automatic, non-elective earnings deferral is expected to ease some of these concerns for private sector DC plans.

Less Flexibility for Recognizing Outside Service and Less Effective at Motivating and Retaining Employees: Without the tools available to a more complex DB plan, DC plans cannot easily recognize outside service credit. Similarly, DC plans do not provide the motivation and retention advantages built into DB plans.

Trends:

Over the past several years the debate between the proponents of defined benefit plans and defined contribution plans has intensified. Recent examples are provided below of retirement systems switching from DB to DC, or adding separate DC options.²¹ A small number of examples are provided of a closed statewide DB plan being reopened for members forced into the DC plan and the creation of hybrid plans established alongside existing DC plans.

In the corporate, private sector environment, a clear trend of defined benefit plan closing has emerged. It is unclear whether or not this trend will play out in the public sector. On balance, to

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Defined Contribution Retirement Plan Study, prepared by GRS for the New Mexico Educational Retirement Board, 2005.

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Benefits Review Study of the Nebraska Retirement System, Buck Consultants, August 2000 (which supported the decision to change from a DC plan to a hybrid plan in Nebraska).

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Overview of Plan Types and Their Use Among Statewide Retirement Systems, NASRA, April 2007, Exhibit “2”; *Defined Contribution Experience in the Public Sector*, Mark C. Olleman, *Benefits & Compensation Digest*, February 2007.

the extent that a trend can be identified in the public sector, DC alternatives/hybrid and/or cash balance plans are being created within and alongside DB plans.²²

In 2005, the State of Alaska closed its DB plan for all state employees hired after June 2006, leaving the Alaska Railroad Retirement Plan as the only open public employee DB retirement system in the State of Alaska. The state DB plans continued for existing members. The Municipality of Anchorage maintains a closed DB plan for its public safety employees. It is considering re-opening this plan to enhance recruitment opportunities. A bill is pending in the Alaska Legislature to re-open the state DB plan.

In 2004, California Governor Arnold Schwarzenegger proposed closing California's DB plans in favor of the creation of a new DC system for future employees. After vocal opposition by labor and employee groups, the Governor withdrew his initiative proposal. Earlier this year, the California Foundation for Fiscal Responsibility proposed a less ambitious proposal which would leave existing DB plans intact, but impose benefit limitations and benefit caps.²³ The proposals have considerable constitutional impediments.

In 2004, Colorado established a DC option for new state employees beginning on January 1, 2006.

In 2003, Oregon created a hybrid plan for new Oregon employees in lieu of the traditional DB plan. The hybrid plan uses a 1.5% DB multiplier (1.8% for public safety) funded by the employer, along with a mandatory employee contribution into the DC plan.

In 2002, Nebraska established a hybrid cash balance plan for new state and county employees and existing DC plan participants electing to switch into the new cash balance plan. The hybrid plan was created in response to concerns that employees were not accumulating enough retirement savings in the stand-alone DC plan.

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It should be recognized that public sector/governmental DB plans have at least three comparative advantages over their private sector counterparts. First, private sector plans are required to participate in the Pension Benefit Guarantee Corporation (PBGC) insurance program and make insurance premium payments to the PBGC. As a result, corporate DB plans have moderately higher costs, since well managed plans are required to pay insurance premiums based on the liability of other less well managed plans. Second, governmental DB plans are not subject to the "going concern" default scenario facing private sector employers. The risk that a private employer will go out of business is a fundamentally different risk which does not exist for public DB plans. Third, governmental plans are permitted a degree of actuarial flexibility which is not available in the private sector. For example, governmental DB plans are not forced to periodically change their liabilities based on interest rate levels, which results in greater contribution volatility for private sector plans.

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The California Foundation *for* Fiscal Responsibility's press release, Exhibit "16", is available at www.californiapensionreform.com/initiative_press_release.htm; a copy of the 2007 initiative, Exhibit "17" is available at www.californiapensionreform.com/initiative_text.htm

In 2002, members of the Montana PERS were given the option of switching from the state's DB plan into a DC alternative during a one-year open enrollment process. Approximately 3% of eligible employees elected to transfer to the DC plan.

In 2000, Florida modified its traditional DB system to give FRS participants the option to move into the newly created Florida Investment Plan, a DC alternative.²⁴ After spending \$89 million to set up these DC accounts, initially fewer than five percent of eligible participants opted to move into the new FRS DC program.²⁵ Since 2002, the track record has been better and more new hires have begun electing the state's DC plan.²⁶

Beginning in 2000, South Carolina teachers and educational employees were given the option to participate in a DC plan as an alternative to the state's DB plan. The option was extended to other state and local government employees in 2002. Approximately 17% of employees elected to switch to the DC plan.

In 1998, Ohio created an optional DC plan for new educational employees not yet vested in the state DB plan. Eligible employees were given three options, remain in the DB plan, or switch to a DC plan, or a hybrid plan. The options were subsequently extended to teachers in 2001 and local government employees in 2002. Approximately 95% of active employees elected the DB plan or the hybrid plan, with the vast majority electing to remain in the traditional DB plan.

West Virginia closed its teachers DB plan in 1991, requiring all new teachers to join a new DC plan. According to an actuary for the West Virginia teacher retirement system, the new private account system was more expensive than the old DB pension system. The actuary for West Virginia also found that switching back to a traditional DB pension system would save taxpayers millions of dollars annually in pension contributions. As a result, West Virginia switched back to a traditional DB plan in 2005. Participants in the DC plan switched en masse to the reopened DB plan.

At the time West Virginia switched back to a DB plan only 105 out of 1767 teachers over age 60 had a DC account in excess of \$100,000. An account that size would yield a monthly annuity of

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The FRS Investment Plan is also known as the Public Employee Optional Retirement Program, a 401(a) DC plan that employees may select in lieu of membership in the traditional DB plan, the FRS Pension Plan.

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Florida State Board of Administration Fact Sheet, *Update on Choice in the Florida Retirement System*, March 31, 2007, <http://sbafla.com/pdf/news/Update%20on%20Choice.pdf>.

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Florida State Board of Administration Fact Sheet, *Update on Choice in the Florida Retirement System*, March 31, 2007, Exhibit "18", pages 3-4. On an annual basis, the percentage of new employees electing the Florida Investment Plan has ranged from 8% in 2003 to 21% in 2006. During the first quarter of 2007, 26% of new hires elected the FRS Investment Plan and 74% elected or defaulted into the FRS Pension Plan. Of the total of 695,622 FRS members on March 31, 2007, 89% were participating in the FRS defined benefit Pension Plan and 11% were participating in the defined contribution Investment Plan.

approximately \$600 beginning at age 65. The average balance was just under \$42,000, a sum which is incapable of supporting any meaningful retirement.²⁷

Following the economic devastation of Hurricanes Katrina and Rita, Louisiana considered the elimination defined benefit programs for future employees, but ultimately rejected the idea. The Legislature relied on a 2005 report from the Public Affairs Research Council, a non-partisan research and public advocacy group which concluded:

Nearly all states use DB plans as their primary pension plans. A DB plan is the appropriate vehicle for providing most public sector pensions. It encourages career employment and public employees are less mobile than private sector workers. The DB plan can provide better benefits than an equally funded DC plan, because a pension system can spread risk and invests more effectively than most individuals, who tend to invest more conservatively. The DB plan provides security whereas a DC plan would leave employees vulnerable. Recent studies show that employees tend to cash out their DC accounts, fail to reinvest the with new employer's plan and spend lump-sum distributions, leaving them much reduced retirements. The DC plan serves well for certain short-term positions and as a supplement to a DB plan, but is inadequate as a general primary pension plan. ²⁸

Cost Considerations:

Based on NCPERS' national statistics, on average governmental employers contribute less than 26 cents for every dollar paid out in DB pension benefits. The remainder is funded by investment income and employee contributions. Most state and local workers are required to pay employee contributions into their public DB pension plans, which is not the case for corporate DB plans.²⁹

Closing a DB plan does not result in immediate cost savings. According to Government Accounting Standards Board (GASB) accounting rules, plan sponsors are required to accelerate the funding of benefits in a closed plan. The actuarial methodology would necessarily change in

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Levitz, J, "When 401(a) investing goes bad: Teachers in West Virginia offer a valuable lesson for what not to do" *The Wall Street Journal*, August 4, 2008.

28

Public Employee Retirement, Time for Change. Public Affairs Research Council of Louisiana, Analysis No. 306, Baton Rouge, La. 2005. <http://www.la-par.org/Publications/PDF/RetirementReport2005.pdf>

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NCPERS fact sheet 1, *Traditional Pensions: A Tried & True System that Benefits Taxpayers.*

a manner which accelerates the payment of plan liabilities over a shorter period, resulting in a spike in employer contribution rates. Since new employees are no longer participating in the closed DB plan, their salaries will no longer be included as a basis for making contributions to amortize the existing UAAL (unfunded actuarial accrued liability) amount. Thus, employer contributions to the UAAL will be paid out as a percentage of salary for a declining group, resulting in a higher employer amortization payment.³⁰ Additionally, offering a DC and DB option may increase costs due to adverse selection. Informed employees should opt for the program they anticipate will best match their career plans. As a result, the average entry age in the DB plan may increase while actuarial savings due to turnover may decrease.³¹

In 2005, when the State of California was considering closing its DB plan in favor of a DC plan for new employees, the transition cost was estimated at \$7.6 billion.³² Under the most optimistic assumptions, it was projected that cost savings would not be realized for at least 10 years. In the case of Los Angeles County, a March 2005 actuarial study found that the county would not see any net savings for over 20 years, in 2028.³³ The first annual savings would not occur until 2019/2020. The Los Angeles County study further found that the required County contribution rate would increase by 4.85% of pay.

Stated mathematically, $\text{Benefits} = \text{Contributions} + \text{Investment Earnings} - \text{Expenses}$. Greater benefits can only be gained by higher contributions, greater earnings or lower expenses. According to a study performed by the defined benefit Kansas Public Employees Retirement System, any conversion to a DC plan needs to address the current low level of DC contributions. The assumption that superior investment returns can consistently be earned by DC participants “contains the seeds of grave danger for future Kansas retirants and taxpayers.”³⁴

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Milliman study for Los Angeles County, forth in March 2, 2005 letter to Marsha Richter, Chief Executive Officer for the Los Angeles County Employees Retirement Association (LACERA).

31

Study of Retirement Plan Designs for the State of Colorado Office of the State Auditor, Buck Consultants, November 2001.

32

NCPERS fact sheet 1, *Traditional Pensions: A Tried & True System that Benefits Taxpayers*.

33

The Milliman study is set forth in a letter to Marsha Richter, Chief Executive Officer for the Los Angeles County Employees Retirement Association (LACERA) dated March 2, 2005.

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Plan Design: A Review of Current Public Pension Issues, Kansas Public Employees Retirement System, January 2000.

Increasingly, public employers are being urged to use caution in making changes to their retirement programs in response to the current economic conditions.³⁵

At least one Florida municipality attempted to close its defined benefit plan and avoid the unfunded liability. The Fourth District Court of Appeal required the city to fully fund the now-terminated plan finding it had a constitutional and statutory duty to honor its retirement obligations. See, *Board of Trustees v. Town of Lake Park*, 966 So.2d 448 (Fla. 4th DCA 2007). Similar results have been reached in courts throughout the country.

The primary purpose of municipal government is to provide for the safety and welfare of its citizens. More than any other level of government, the cities, counties, and states meet the immediate needs of its citizens for the most basic governmental services. To ensure the continued high level of public service that citizens have come to expect, an employer's benefit program must remain competitive. Material changes in the current programs will take employers out of a competitive position in the relevant labor market and will make its workforce, particularly among less tenured employees, vulnerable to competing offers.

A prudent pension board must be committed to the efficient administration of the plan in accordance with expected fiduciary standards. It must be keenly aware of the need to conduct business in a fiscally responsible manner which maximizes return with a reasonable level of risk on investments. This will, over time, lead to the decline in employer contributions without any loss of employee benefits or plan security.

The oldest continuous operating public employee pension plan began operation in the 1880's. It is a program that made sense when it was adopted and makes even greater sense today. The City of North Miami Beach's DB plans date back decades and have ensured a stable, skilled workforce at all levels.

In a recent article, the *Journal of Pension Benefits* explores the reasons for the continued resilience of governmental DB plans. Among the reasons for the durability of DB plans in the public sector is the fact that DB pensions "work for taxpayers" by squeezing more value out of each dollar contributed. The author also concludes that DB plans "work for employees" by providing life-long retirement security and stable income for retirees.³⁶

Participants in 457 plans have seen a 25-30% decline in the value of their deferred compensation accounts. For employees on the verge of retirement, such a loss would be catastrophic were it not for the security of their defined benefit retirement plan.

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Boivie and Almeida, "Look Before you Leap : the Unintended Consequences of Pension Freezes," National Institute on Retirement Security, October 2008.

36

Beth Almeida, *DB Pensions: The Real Deal*, The Journal of Pension Benefits, July 2010

It is important to remember that retirement plans operate in 30-year time horizons. Short term reactions to long-term programs are disruptive and ultimately diminish the likelihood of economic success in those plans.

IF YOU HAVE ANY QUESTIONS CONCERNING THS PRESENTATION, PLEASE CONTACT ROBERT D. KLAUSNER, KLAUSNER & KAUFMAN, P.A., 10059 NW 1 COURT, PLANTATION, FLORIDA 33324, TELEPHONE: (954) 916-1202; FAX: (954) 916-1232; WEBSITE: www.robertdklausner.com