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CSG Policy Academy

Public Pension Issues in 2014 and Beyond

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THE SEGAL GROUP
Founded in 1939

What Are We Really Talking About Today?

- Purpose of any retirement system:
  - Convert taxpayer dollars into retirement security for workers

- Cultural references to financial security in old age:
  - "You can be young without money but you can't be old without it."
    – Maggie, in Cat on a Hot Tin Roof,
    Tennessee Williams, 1955
  - "God forgive me, but an old person without money is pathetic."
    – Woman 3, in Voices Of Old People from "Bookends",
    Simon And Garfunkel, 1968

Retirement Plan Terminology Issues

- Tradition - and Webster - define “pension”:
  - “a fixed sum paid regularly to a person”
- From a California “Pension Reform” Proposal:
  - Defined Benefit Plan:
    “System providing a pension benefit determined by a formula based on age, service credit, and final salary”
  - Defined Contribution Plan:
    “System providing a pension benefit that is equal to the combined employer and employee contributions plus interest, less administrative expenses”

Retirement Plan Terminology Issues

Keep your eye on the Pension		
	"DB"	**"DC"**
Retirement Need	Income Replacement	Capital Accumulation
Type of Plan	Pension Plan	Individual Account Plan
Form of Benefit	Annuity	Account Balance

Slippery Terminology

- No such thing as a "Defined Contribution Pension Plan"!
- A true pension plan must address the "annuitization risk"
  - For true retirement security, at some point the account balance must convert to an annuity
- An individual account plan is not a pension plan
  - Fundamentally different type of benefit
  - Not interchangeable
  - Watch out for studies that equate a pension promise to a "wealth transfer"
- Warning: Beware of Cash Balance "Hybrids"

Hybrid Plans in the Public Sector

- "Hybrid" can refer to two very different types of plan design
- "Combination Plan" Hybrid
  - This classic design is really two separate plans
  - Pension Plan for Income Replacement
  - Individual Account Plan for Capital Accumulation
- "Cash Balance" Hybrid
  - Legally a "Defined Benefit" Individual Account Plan
  - Originally developed to allow corporate sponsors to strip the pension promise out of their defined benefit pension plans
  - Most cash balance plan designs <u>do not</u> address the annuitization risk

Why the Pension Matters: Economic Efficiency

- Basic rule of retirement plan economics:

$$C + I = B + E$$

Contributions + Investment Income

equals

Benefit Payments + Expenses

- Individual Accounts Plans may have lower Income and higher Expenses compared to Pension Plans

- If so then plan must receive higher Contributions to provide the same level of retirement security

Evaluating Economic Efficiency

- Consider how plan performs during two phases:
  - Accumulation period
  - Payout period
- Key design issue for cash balance plans during payout period
  - Will cash balance plan provide annuity option?
  - If not then conversion to pension requires annuity purchase
    - Annuities provide lower investment returns, with high expenses
  - If so, what earnings assumption does cash balance plan use to convert account balance to an annuity
    - If same as long term earnings, then no loss of efficiency
    - If less (market rate) then less efficient than a pension plan

Remember Why We Are Here

C + I = B + E

- A Pension Plan (income replacement) is the most economically efficient vehicle for converting taxpayer dollars into retirement security

- An Individual Account Plan (capital accumulation) can provide for transition expenses, supplemental income
  - Also, non-retirement uses

- An Individual Account Plans can complement, but not replace, a true Pension Plan got pensions?