Public Pension Issues in 2014 and Beyond

Anchorage, Alaska
August 9, 2014

Paul Angelo, FSA
Segal Consulting
San Francisco
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.”
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

<table>
<thead>
<tr>
<th>Keep your eye on the Pension</th>
<th>“DB”</th>
<th>“DC”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retirement Need</td>
<td>Income Replacement</td>
<td>Capital Accumulation</td>
</tr>
<tr>
<td>Type of Plan</td>
<td>Pension Plan</td>
<td>Individual Account Plan</td>
</tr>
<tr>
<td>Form of Benefit</td>
<td>Annuity</td>
<td>Account Balance</td>
</tr>
</tbody>
</table>
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 do not 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
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.

Remember Why We Are Here

\[ C + I = B + E \]
got pensions?