Countering the Attack on Public Pensions with Facts

NAPO 28th Pension & Benefits Seminar

January 25, 2016

Diane Oakley, Executive Director

NATIONAL INSTITUTE ON Retirement Security

Reliable Research. Sensible Solutions.

Agenda: Building a Fact-Based Tool Kit for DB Plans

» Strengths of DB Pensions that Deliver Economic Efficiency
» Workforce Management and DB Plans
» Funding Attack on DB Pensions
» Lessons from Switching to DC Plan
» Pensionomics
» Public Opinion
» Q&A

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Why Revise "A Better Bang for the Buck"Study?

- Updated assumptions, methodology to reflect changing retirement benefit landscape
  - DC plans: lower fees, increased use of Target Date Funds (TDFs), and better understanding of participant investment actions.
  - DB asset allocation changes.

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3 Key Reasons that DB Plans Save Money Compared to DC Plans

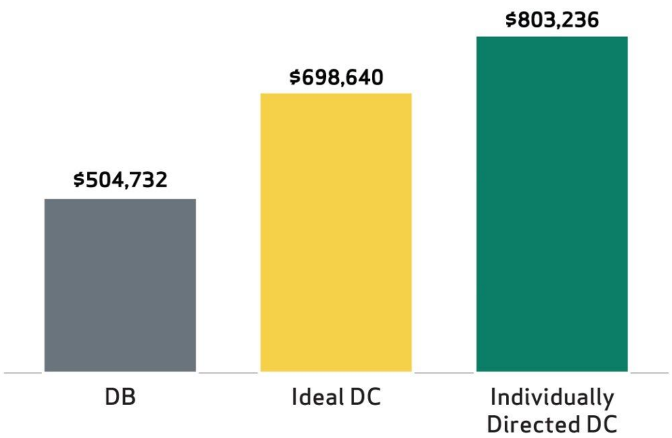
1. Pool the longevity risks of large numbers of individuals.

2. Perpetually maintain optimally balanced investment portfolio compared to down-shifting to over time to a lower risk/return asset allocation.

3. Achieve higher investment returns as compared to individual investors because of professional asset management and lower fees.

Target: Monthly Income of $2,700 at Age 62 and Compares 3 Plan Designs

Figure 7:
Per Employee Amount Required at Age 62
DB Plan vs. DC Plan



Contribution needed to fund DB plan is 16.3% of payroll.

DB plan

- Typical asset allocation and fees.

Individual Directed DC plan

- Target Date Fund (TDF) – mix equities & fixed investments.
- Average fund fees, modest "behavioral drag."

"Ideal" DC plan

- TDF with same glide path.
- Same DB fees, no behavioral drag
- No individual choice.

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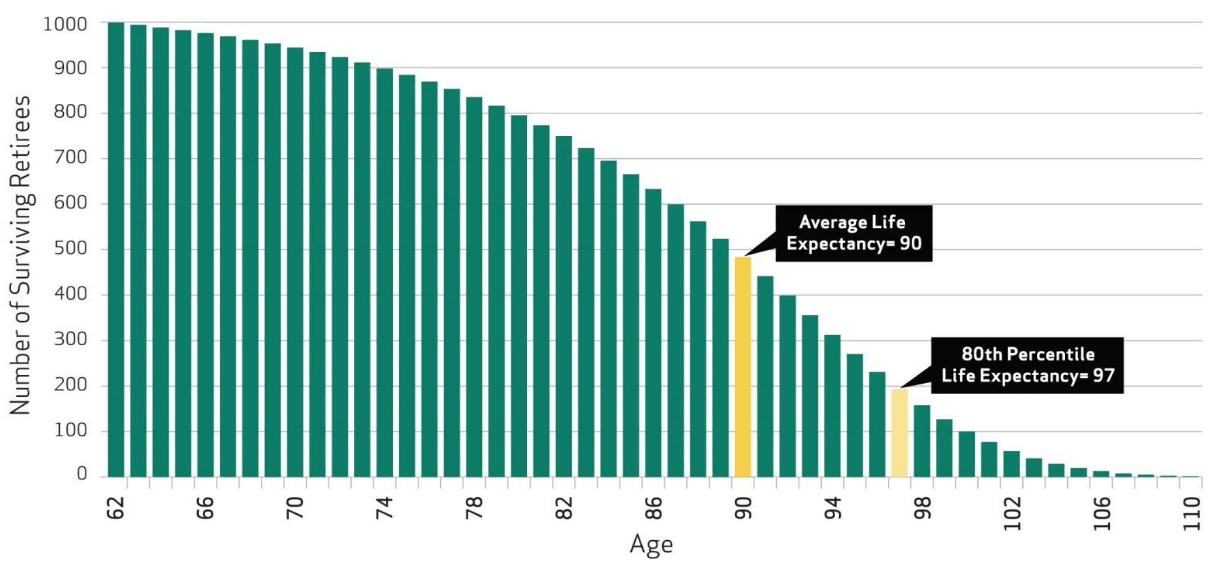
DB Plan Strength # 1

Longevity Risk Pooling

DB plans can be funded to last the **average life expectancy** for each participant , but an individual using life expectancy has a 50-50 chance of running out of money.

Figure 2: **Longevity of 1,000 Retired Female Teachers**



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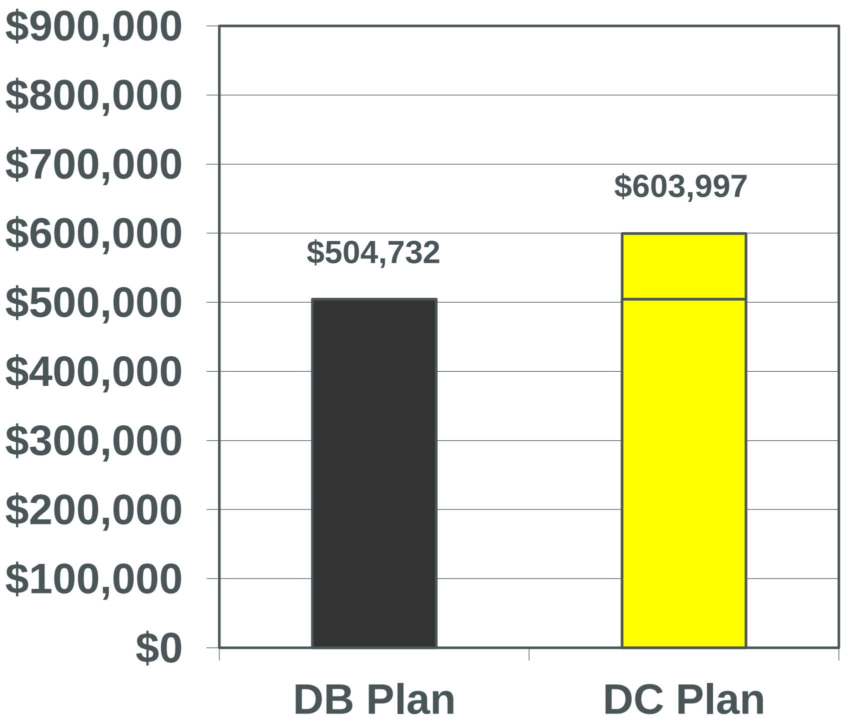
Lack of Longevity Risk Pooling Drives Up Cost in DC Plans

- To "self-insure" longevity risks – a retiree at age 62 needs about **$600,000** in DC plan for same monthly income.

- Based on an individual having a 1 in 5 chance of outliving savings.

- Contributions must be **19.6%** of payroll for this protection.



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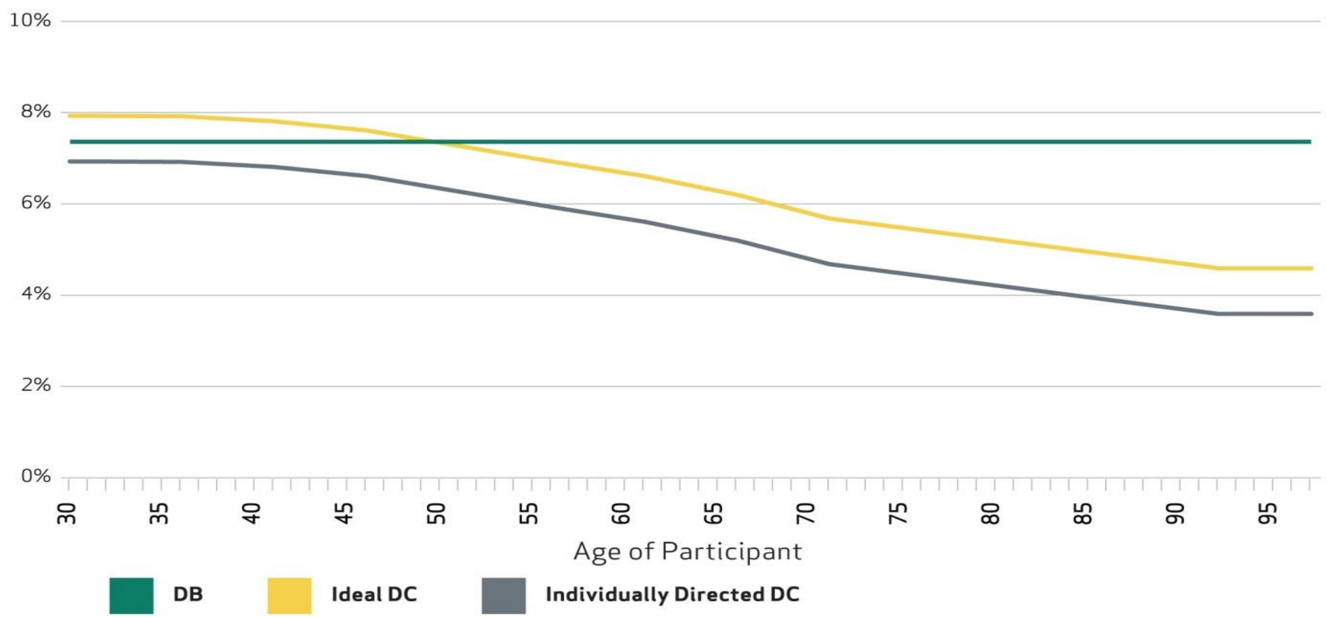
DB Plan Strength #2

Maintenance of Portfolio Diversification

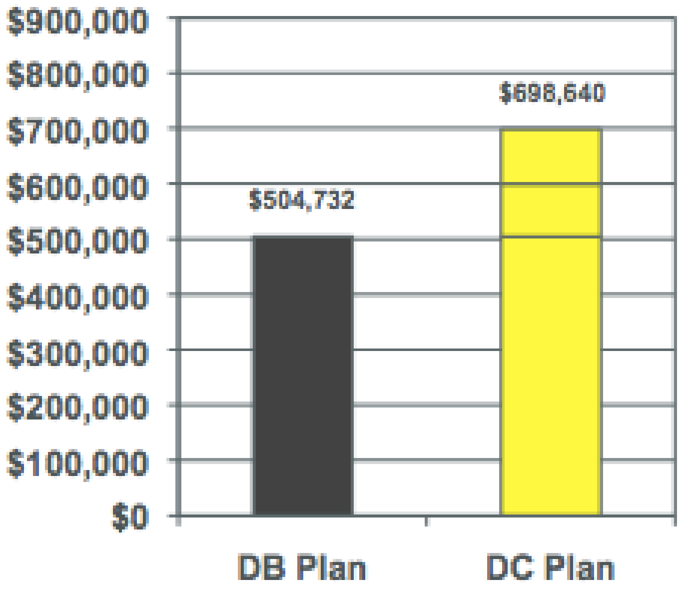
In a DC account, individuals must adjust risk as they age to protect against market shocks, sacrificing some expected return.

Figure 6: **Expected Annual Investment Return (Net of Fees)**



Age-Driven Shift to More Conservative Portfolio in DC Plans Drives Up Cost

- A retiree in the DC plan must have nearly **$700,000** account balance at age 62.
- In order to fund this amount, contributions must be **23.0%** of payroll.
- This summarizes the **"Ideal" DC plan** cost.



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DB Plan Strength #3

Lower Fees & Professional Management

- Pooled investments can lower expenses.

- While DB plan investments are professionally managed, individuals tend to underperform
  - Individual investor level returns lag behind long-term returns for any asset class, and most mutual funds.
  - Failure to re-balance, poor timing
  - "Behavioral drag" estimates range from 98 bp to over 200 bp.

- Conservatively assume additional 1.00%,
  - 40 bp additional DC expenses,
  - Optimistic 60 bp for "behavioral drag"

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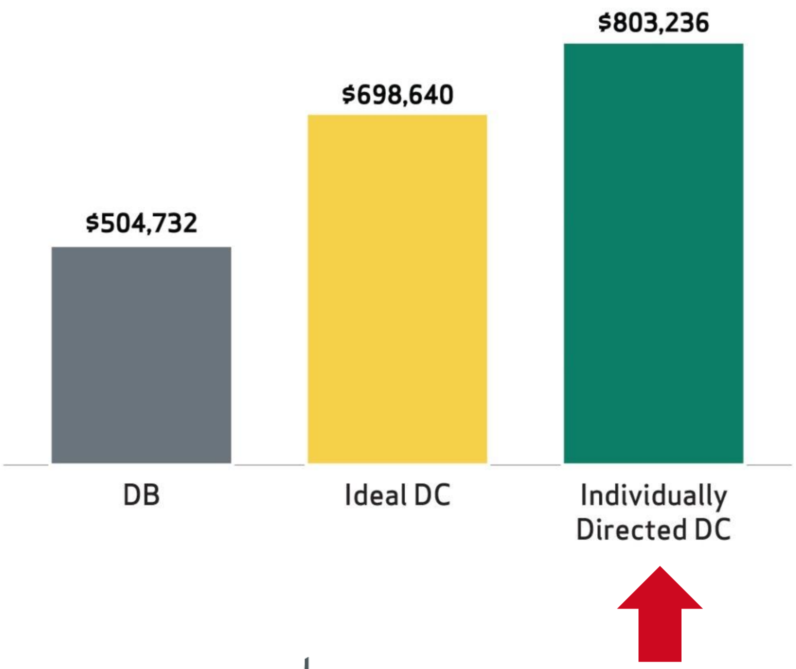
Lower Returns/Higher Fees in DC Plans Drive Up Cost

- Each retiree in the DC plan now must have more than **$800,000** in account at age 62.
- In order to fund this amount, contributions must be **31.3%** of payroll.

Figure 7:
Per Employee Amount Required at Age 62 DB Plan vs. DC Plan



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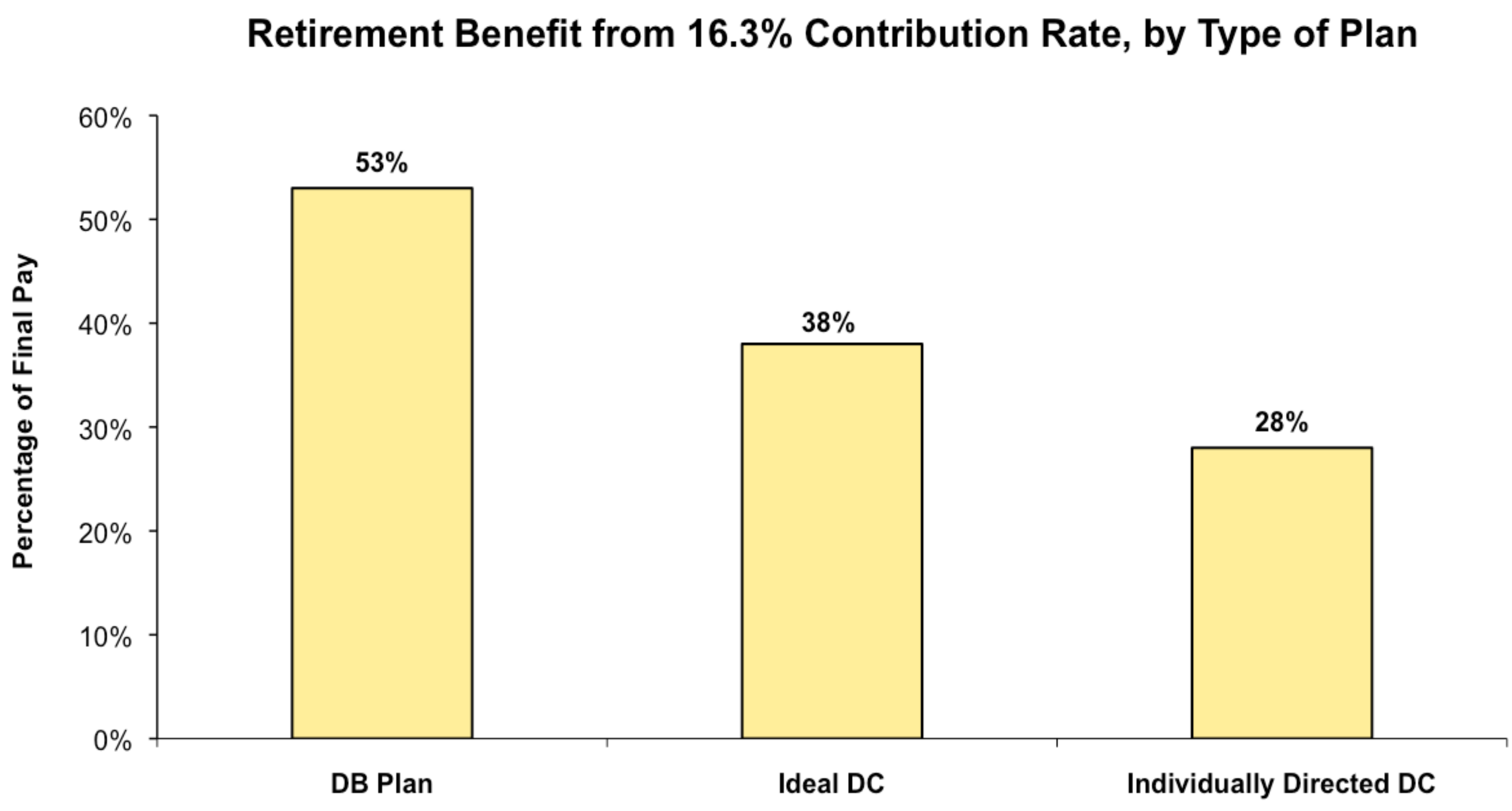
Tallying DB Plan Cost Savings
Compared to a Typical DC Plan

1. Longevity risk pooling saves	**10%**
2. Maintenance of portfolio diversification saves	**11%**
3. Lower fees & professional management saves	**27%**
All-in costs savings in DB plans	**48%**

In other words - a DB plan can provide the same benefit at almost half the cost of a DC plan

Fiscal Reality is that cost can't increase – What if same cost?



Additional Sensitivity Analyses

- Variations in assumptions still show significant DB-DC disparity
  - Returns.
  - Expenses and Behavioral Drag.
- Include public safety employee
  - Male, retire at 55, no Social Security.
  - DB saves 46% compared to typical DC (vs. 48% baseline).

Colorado Pension Design Study

A Comprehensive Study Comparing the Cost and Effectiveness

Office of the State Auditor Considered Alternative Plan Designs Costs

SAME BENEFIT for a 30-year Employee at 65 Costs 60% more.

Comparison of Defined Benefit and Defined Contribution Side-by-Side Plan with PERA Hybrid Defined Benefit Plan					
Targeted Benefit Approach State Division					
				PERA Hybrid Defined Benefit Plan	Defined Benefit and Defined Contribution Side-by-Side Plan[1]
Employer Contribution[2]				0.82%	5.29%
Member Contribution[2]				8.00%	9.03%
Relative Cost (to replace the same age-65 benefits as under the PERA Hybrid Defined Benefit Plan)				100%	160%
REPLACEMENT RATIOS (set equal at age 65 with 30 years of service)					
Age at Hire	Age at Termination	Years of Service	Benefit Commencement Age		
35	65	30	65	72.2%	72.2%
35	62	27	62	62.5%	61.0%
35	60	25	60	49.7%	50.2%
40	60	20	65	39.6%	43.3%
25	45	20	65	20.6%	32.5%
40	50	10	65	13.0%	18.0%
40	43	3	65	4.4%	2.0%

Source: Gabriel, Roeder, Smith & Company.

[1] **Features of the Alternative Plan:** Defined benefit plan multiplier of 1.50% of final 3 year's pay, the Employer contributes 5.29% of pay. Defined Contribution Plan: Members contribute 9.03% of pay, the Employer contributes 0% of pay, the fund earns 5.5% return each year; the account balance at age 65 is converted to a lifetime annuity based on 5.5% and the valuation mortality table.

[2] Contribution amounts are calculated as a percentage of employee salary.

Source: Colorado Office of the State Auditor and GRS

Colorado Pension Design Study

A Comprehensive Study Comparing the Cost and Effectiveness

Office of the State Auditor Considered Plan Benefits from Alternative Designs

SAME COSTS: Benefits 54.4% of pay compared to 72.2%

Comparison of Defined Benefit and Defined Contribution Side-by-Side Plan with PERA Hybrid Defined Benefit Plan					
Targeted Contribution Approach State Division					
				PERA Hybrid Defined Benefit Plan	Defined Benefit and Defined Contribution Side-by-Side Plan[1]
Employer Contribution[2]				0.82%	5.29%
Member Contribution[2]				8.00%	3.53%
Relative Cost (set equal)				100%	100%
REPLACEMENT RATIOS					
Age at Hire	Age at Termination	Years of Service	Benefit Commencement Age		
35	65	30	65	72.2%	54.4%
35	62	27	62	62.5%	46.5%
35	60	25	60	49.7%	37.7%
40	60	20	65	39.6%	31.3%
25	45	20	65	20.6%	20.1%
40	50	10	65	13.0%	11.7%
40	43	3	65	4.4%	0.8%

Source: Gabriel, Roeder, Smith & Company.

[1] **Features of the Alternative Plan:** Defined benefit plan multiplier of 1.50% of final 3 year's pay; the Employer contributes 5.29% of pay. Defined Contribution Plan: Members contribute 3.53% of pay, the employer contributes 0% of pay, the fund earns 5.5% return each year; the account balance at age 65 is converted to a lifetime annuity based on 5.5% and the valuation mortality table.

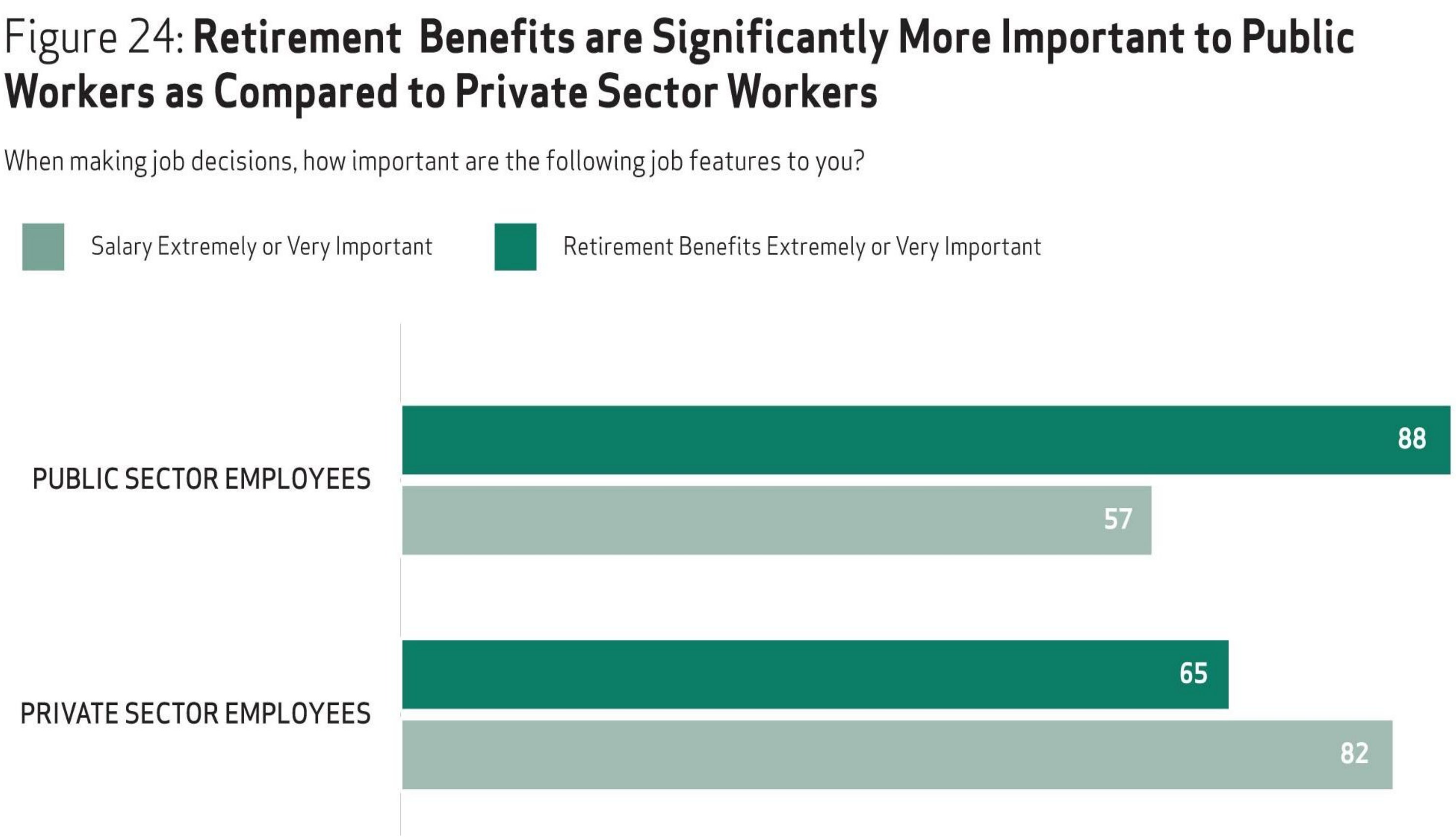
[2] Contribution amounts are calculated as a percentage of employee salary.

Source: Colorado Office of the State Auditor and GRS

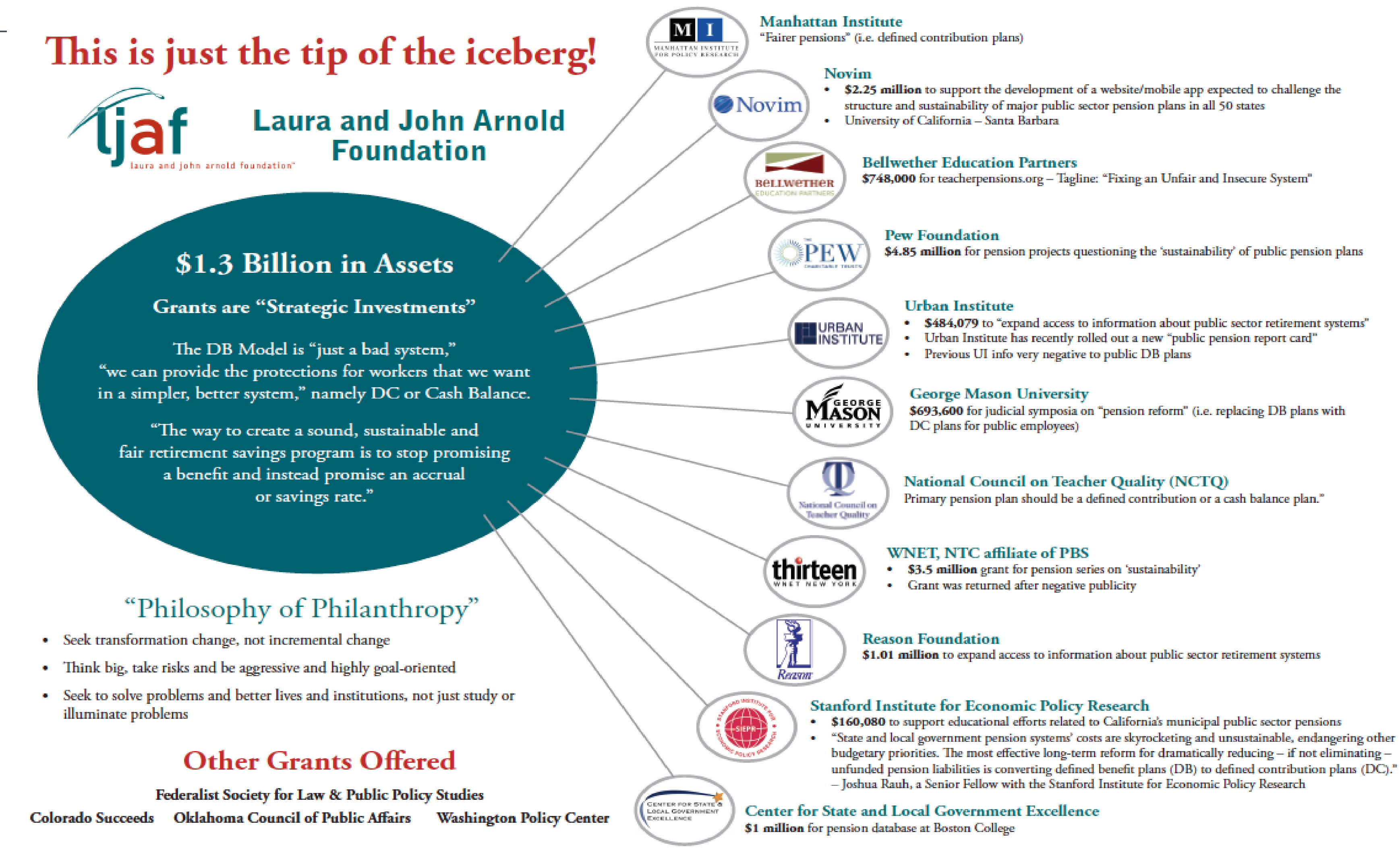
DB Role in the Public Sector: Workforce Management

- DBs may improve public sector productivity:
  - More likely to value their work and tend to invest more in their skills.
- Pensions enable public employers to recruit and retain quality workers from the private sector.
- Moving to a DC design could affect recruitment, retention, productivity among this workforce.
- DB plans encourage "efficient retirement," which is eliminates "job lock" when workers with DC plans cannot retire.

Retirement Benefits More Important Than Salary For Public Employees



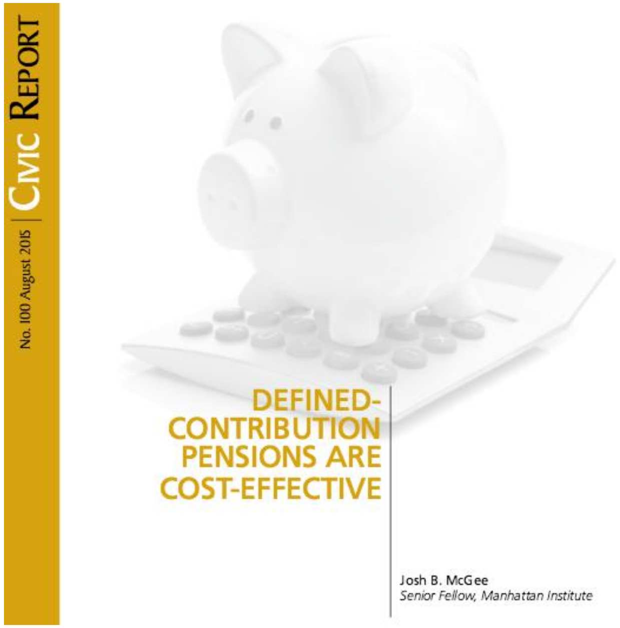
Laura and John Arnold Foundation



Source: Laura and John Arnold Foundation website: www.ljaf.org

Arnold Foundation's Josh McGee Asserts False Claims about NIRS

- DB plans are not more cost-effective than DC plans.
- DC plans achieve similar investment returns.
- DC plans offer annuities.
- Pension debt is a cost driver for DB plans.



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Source: NSCL Conference August 2015

NIRS: McGee Paper Flawed -- Relies Exclusively on Private Plan Data…

Fact Check

- Data misleading
- Not relevant
- NIRS Numbers Add up
- Fair, Accurate Model
- DB investment tops TDF
- DC plan must buy annuity from DB plan.

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The National Institute on Retirement Security's Fact Check On "Defined-Contribution Pensions are Cost-Effective" Paper and "Debunking the Defined Benefit Cost Effectiveness Myth" Presentation to NCSL Summit

The National Institute on Retirement (NIRS) served on a National Conference of State Legislatures (NCSL) panel with Josh McGee of the Manhattan Institute on August 5, 2015. Although it is common practice to provide an advance copy of presentations and research to fellow panelists, Mr. McGee withheld his research paper.

A week after the panel discussion, the Manhattan Institute released the paper, *Defined-Contribution Pensions are Cost-Effective.* Based on NIRS' comprehensive review of this report, which Mr. McGee frequently referenced during his talk, we find that his presentation did not give proper reference or context and could be easily misconstrued. Furthermore, it is clear that the research published by the Manhattan Institute is fundamentally flawed when applied to discussions of public pension systems. The research is not based on public sector plans but instead exclusively uses private sector pension data that is not comparable. Thus, neither have relevance to debate on how to efficiently deliver retirement security to public employees while managing the workforce that delivers key public services to our citizens. More specifically, the Manhattan Institute study is contradicted by -- and fails to refute -- NIRS research in ***Still a Better Bang for the Buck: An Update on the Economic Efficiencies of Defined Benefit Pensions*** *(Still a Better Bang for the Buck)* including:

- The Manhattan Institute paper claims that defined benefit (DB) plans are not structurally more cost-efficient than defined contribution (DC) plans. **Fact: NIRS data and empirical evidence show otherwise. DB pensions can deliver a target retirement benefit at half the cost of a DC account.**
- The paper says DC plans get similar investment returns as DB plans. **Fact: The analysis relies strictly on private sector pension data, and fails to account for asset allocation shifts in private sector DB pension to more conservative, lower-return investments due to increased "frozen" pensions and corporate accounting that makes this private sector data inappropriate for assessing the efficiency of state and local government DB pension systems.**
- The paper indicates that it is incorrect to conclude that DC plans cannot offer annuities to provide lifetime retirement income. **Fact: It does not**

1

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Source: NSCL Conference August 2015

Still a Better Bang Estimated Cost of Annuity Purchase at Retirement

- Annuities protect against longevity risk, but at a cost.
- Buying an insurance company annuity at 62; payroll contributions increase to 25.4% at current rates & 20.9% at historical rates compared to DB plan cost of 16.3% of payroll.

NIRS research on SAFE Annuity Plan: High Cost & Low Protection

- Rate of Return tradeoff: Public DB plan real ROR of 5.4% but Fixed Annuity only 2.8% historical real ROR.(NIRS & CRS)
- Cost of fixed annuities is **57 to 180 percent more** than funding DB pensions.
- State Guaranty Fund protections limited, marketing prohibition, state tax credit for assessments places cost with taxpayers.

NIRS Responding to Arnold Foundation Opinion Piece

NIRS responds to McGee using Manhattan Institute paper to claim a cost efficient DC retirement plan as a solution in Chicago.

CRAIN'S CHICAGO BUSINESS. Print Story Printed from ChicagoBusiness.com

Here's one public pension that survived the 2008 crisis

By: DIANE OAKLEY September 09, 2015

The 2008 financial crisis hurt retirement savings, but we found public defined benefit pensions in red states and blue states that survived the market's free-fall in reasonable shape. Surprisingly, one of those well-funded plans is the Illinois Municipal Retirement Fund.

NEWS: Washington Reopened its Closed DB Plan to New Teachers

BUT Bellwether Claims :

Teacher choices in Washington show popularity of the combined DB-DC Plan.

Combined DB-DC Plan can be attractive to teachers and states.

Finding Common Ground
In Pension Reform:
Lessons from the Washington State Pension System

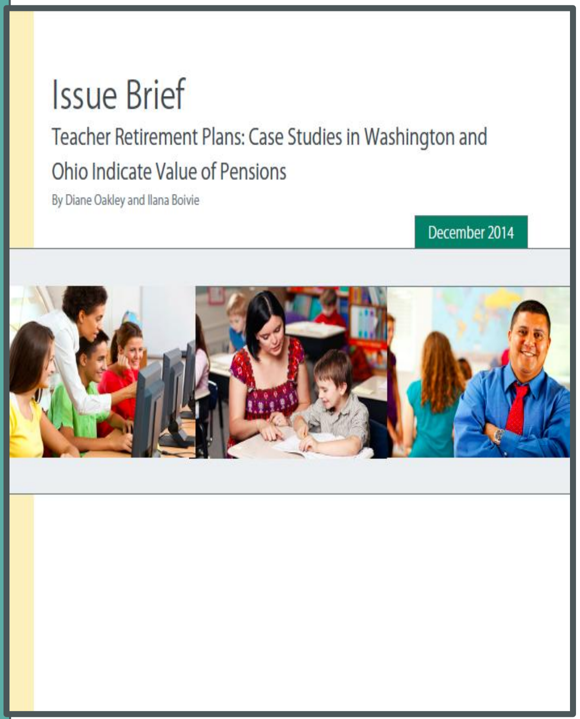
Dan Goldhaber & Cyrus Grout
Center for Education Data & Research
University of Washington

TeacherPensions.org
FIXING AN UNFAIR AND INSECURE SYSTEM

CEDR
Center for Education Data & Research

Bellwether
EDUCATION PARTNERS
IDEAS | PEOPLE | RESULTS

NIRS found in WA and OH Teachers Preferred the DB Plan


Issue Brief

Teacher Retirement Plans: Case Studies in Washington and Ohio Indicate Value of Pensions

By Diane Oakley and Ilana Boivie

December 2014

When given the choice between a DB or Combined DB-DC plan, public employees overwhelmingly choose the DB pension.

Majority of new employees in Washington PERS choose DB pension over Combined DB-DC plan. In Ohio, 86 percent of teachers covered by the DB plan.

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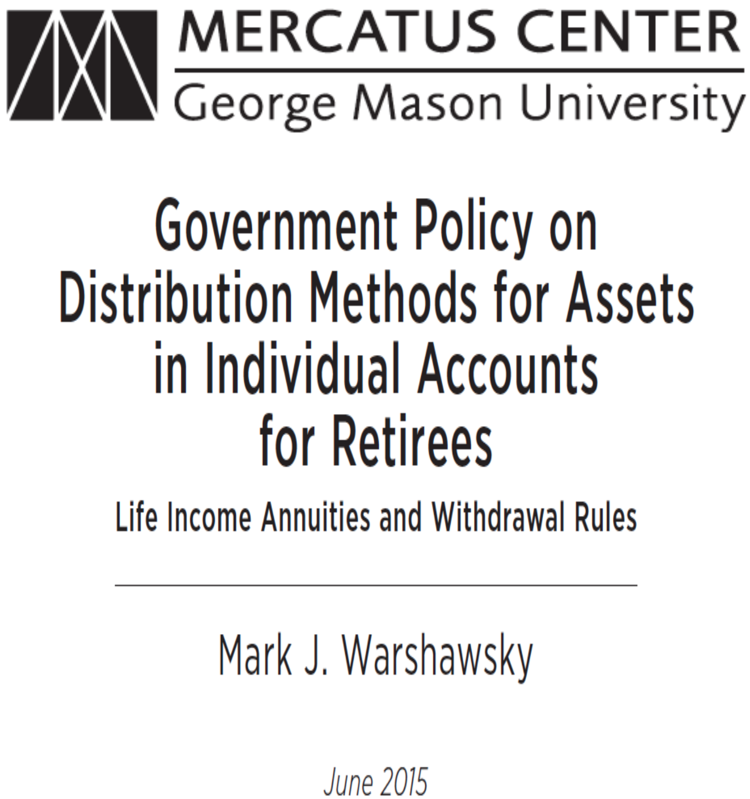
Bait and Switch: Annuities Better than DC: So, DB too?


MERCATUS CENTER
George Mason University

Government Policy on Distribution Methods for Assets in Individual Accounts for Retirees

Life Income Annuities and Withdrawal Rules

Mark J. Warshawsky

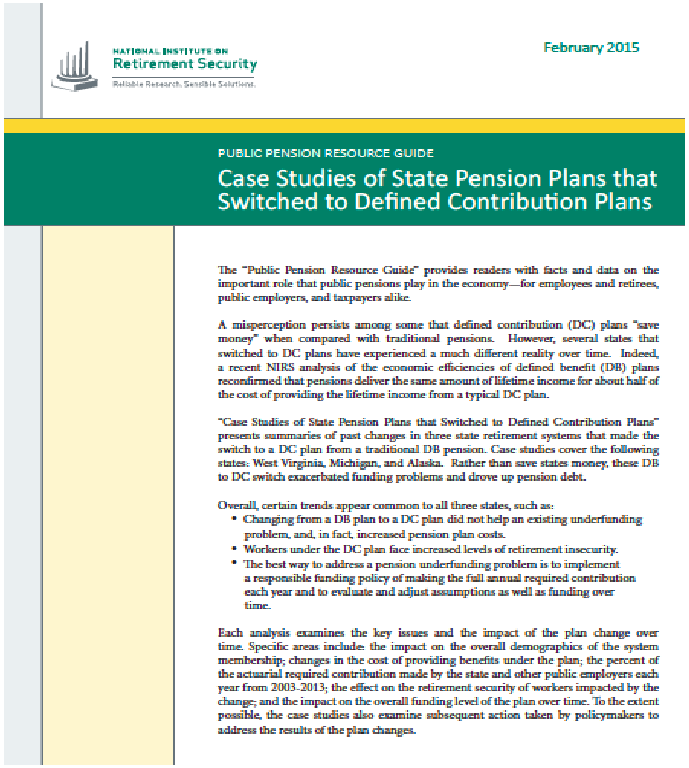
June 2015

- Compares annuity with a 4 percent withdrawal from a DC plan and finds life annuity is more effective.

- Leaps to **suggest an application for annuities to replace public DB pensions** especially in underfunded public plans, which does nothing to address problem.

DB to DC Switch No Help for Funding
NIRS' Case Studies: MI, WI, and AK

1. Changing from a DB plan to a DC **plan did not help an existing underfunding problem; costs increased.**
2. Greater retirement insecurity for workers.
3. Implement a responsible funding policy of making the full actuarial determined contribution each year.



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February 2015

PUBLIC PENSION RESOURCE GUIDE

Case Studies of State Pension Plans that Switched to Defined Contribution Plans

The "Public Pension Resource Guide" provides readers with facts and data on the important role that public pensions play in the economy—for employees and retirees, public employers, and taxpayers alike.

A misperception persists among some that defined contribution (DC) plans "save money" when compared with traditional pensions. However, several states that switched to DC plans have experienced a much different reality over time. Indeed, a recent NIRS analysis of the economic efficiencies of defined benefit (DB) plans reconfirmed that pensions deliver the same amount of lifetime income for about half of the cost of providing the lifetime income from a typical DC plan.

"Case Studies of State Pension Plans that Switched to Defined Contribution Plans" presents summaries of past changes in three state retirement systems that made the switch to a DC plan from a traditional DB pension. Case studies cover the following states: West Virginia, Michigan, and Alaska. Rather than save states money, these DB to DC switch exacerbated funding problems and drove up pension debt.

Overall, certain trends appear common to all three states, such as:

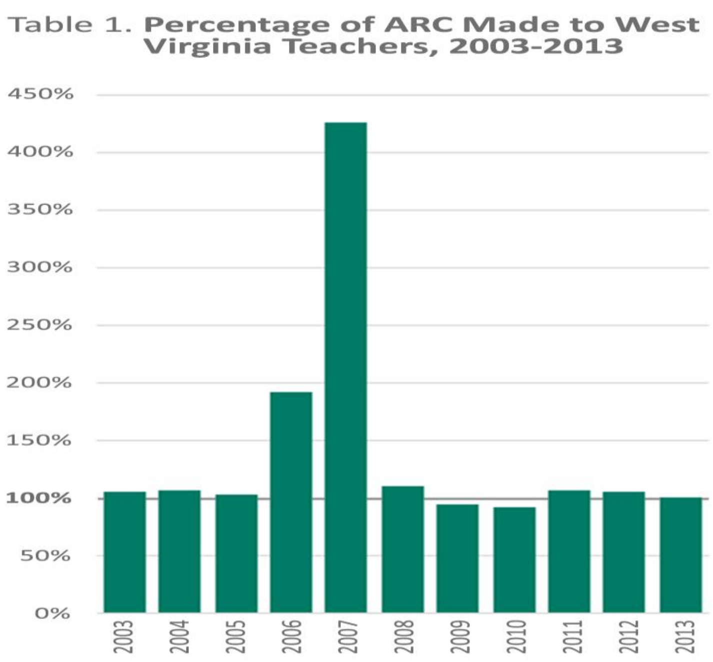
- Changing from a DB plan to a DC plan did not help an existing underfunding problem, and, in fact, increased pension plan costs.
- Workers under the DC plan face increased levels of retirement insecurity.
- The best way to address a pension underfunding problem is to implement a responsible funding policy of making the full annual required contribution each year and to evaluate and adjust assumptions as well as funding over time.

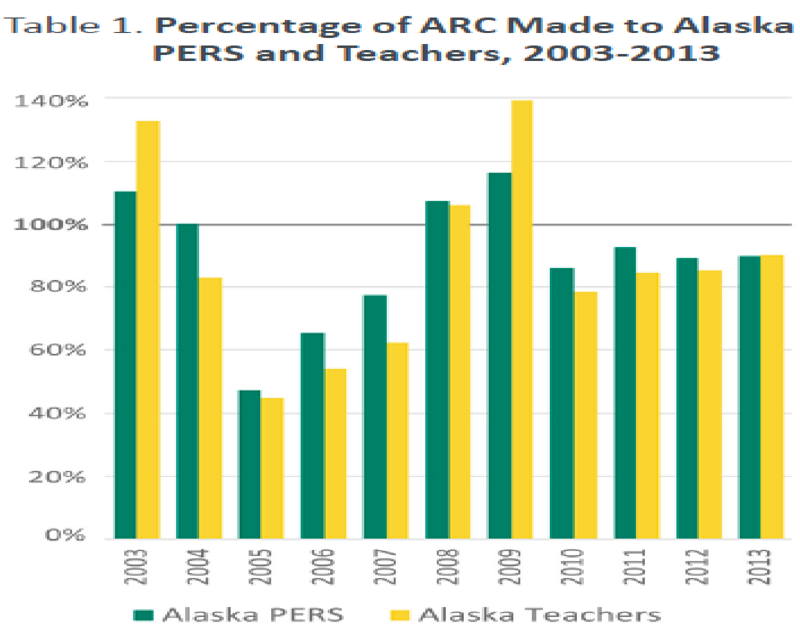
Each analysis examines the key issues and the impact of the plan change over time. Specific areas include: the impact on the overall demographics of the system membership; changes in the cost of providing benefits under the plan; the percent of the actuarial required contribution made by the state and other public employers each year from 2003-2013; the effect on the retirement security of workers impacted by the change; and the impact on the overall funding level of the plan over time. To the extent possible, the case studies also examine subsequent action taken by policymakers to address the results of the plan changes.

Case Studies of WV & AK: Required Contributions not Switch to DC

Best way to address underfunding is to **implement a funding policy of making the full annual required contribution** each year.

Compare West Virginia and Alaska:





Pensionomics: Retirees Spending DB Benefits Fuel…

Expenditures from public and private pension benefits supported in 2012…

- **Over $940 billion** in economic output nationwide
- **Over 6 million jobs** that paid over **$300 billion** in income
- **Over $550 billion** in value added nationally
- **$130 billion** in federal, state, and local tax revenue

Business Stakeholders:
Howell’s Grocery & Restaurant

Illustrating Direct, Indirect, and Induced Impacts

Howell’s Grocery & Restaurant

Situated in the foothills of the Virginia Blue Ridge Highlands, Stuart is an iconic American town. Like other rural towns, small business is central to Stuart’s economy.

Howell’s Grocery and Restaurant is one of the oldest businesses in the town. The Howell family has owned and operated the business since 1924. It is a favorite of locals for a good meal, provides income for its employees and supports other regional businesses.

“I’m getting up there in years, but I love what our restaurant provides – friendship, food, and jobs,” says Leon Howell. Along with his wife Chris, Leon has run the business since taking over in the 1980s after his father passed away.

retirees at Howell’s for a bite to eat. Even during the recession, I still dined out occasionally because my pension income didn’t go down,” Phyllis says

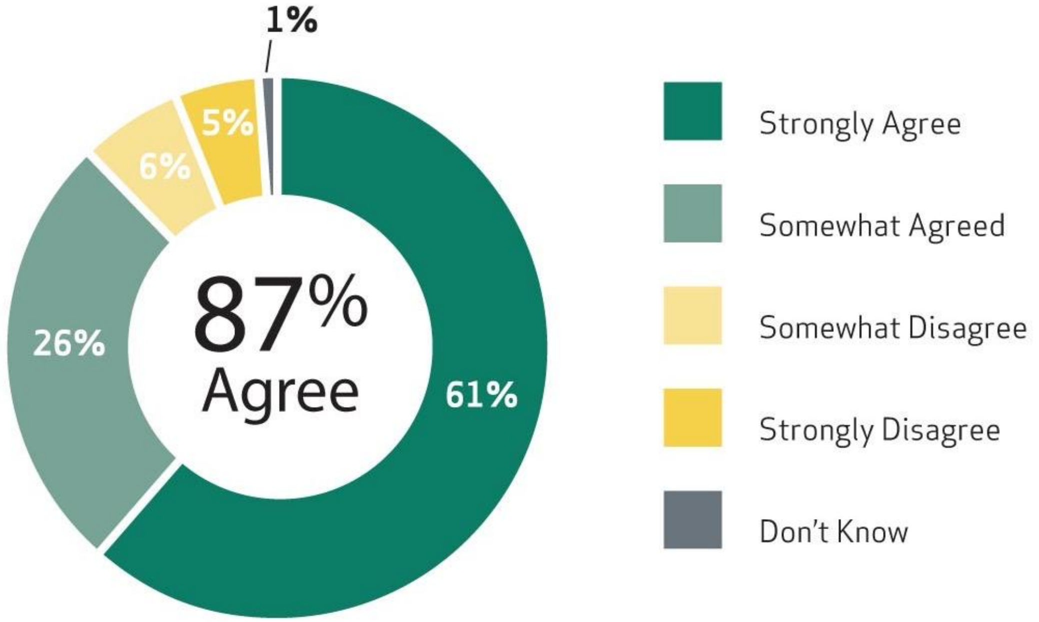
As much as possible, Howell’s purchases its supplies and food from other regional businesses. This is an example of an **indirect economic impact**. As a result of a consumer purchase, a business purchases supplies and services from other businesses, which generates an economic ripple effect.

Then, the owners and employees of Howell’s, and of the businesses that supply goods and services to the restaurant, spend the personal income that resulted from retirees’ pension spending. This is called an **induced economic impact**.

87 Percent: Pensions Are a Tool To Recruit and Retain Public Workforce

Figure 33: **87% of Americans Say Pensions Are Good Tool to Recruit Teachers, Police, Firefighters**

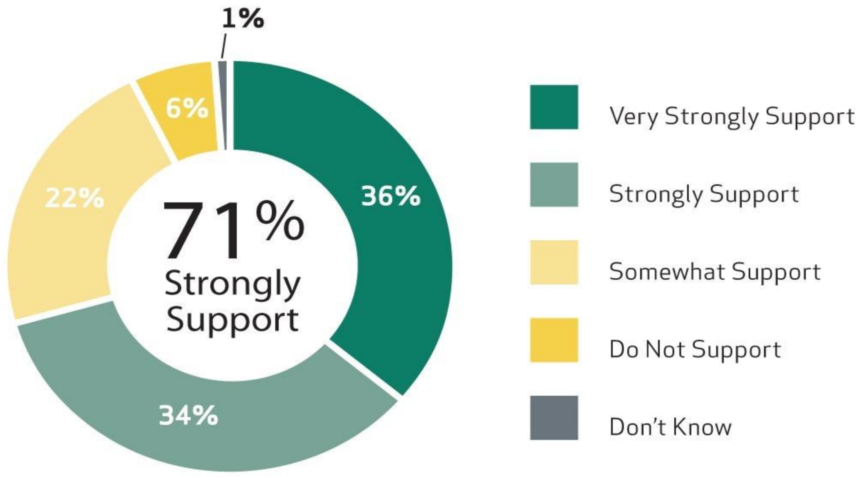
Are pensions a good way to recruit and retain qualified teachers, police officers and firefighters?



More than 7 out of 10 Strongly Support Public Pensions

Figure 29: **71 Percent Strongly Support Local Pensions for Police, Fire, and Municipal Employees Because Workers Help Fund Pensions**

Given that they fund a significant portion of their own pensions, how strongly do you support or oppose giving pensions to local firefighters, police, and municipal employees?



7 out of 10 Americans Strongly Support Public Pensions

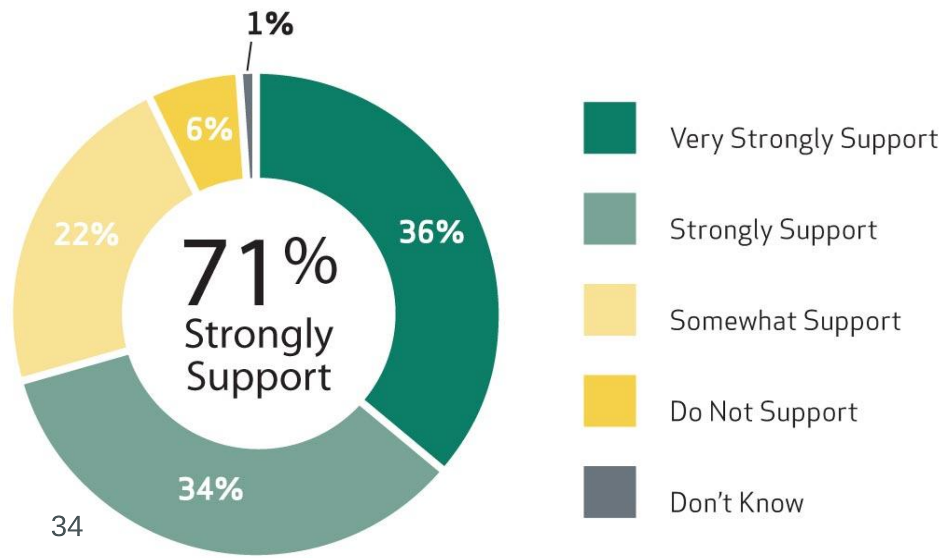
TEXAS:

77% Very/Strongly

96% All Support

Figure 29: **71 Percent Strongly Support Local Pensions for Police, Fire, and Municipal Employees Because Workers Help Fund Pensions**

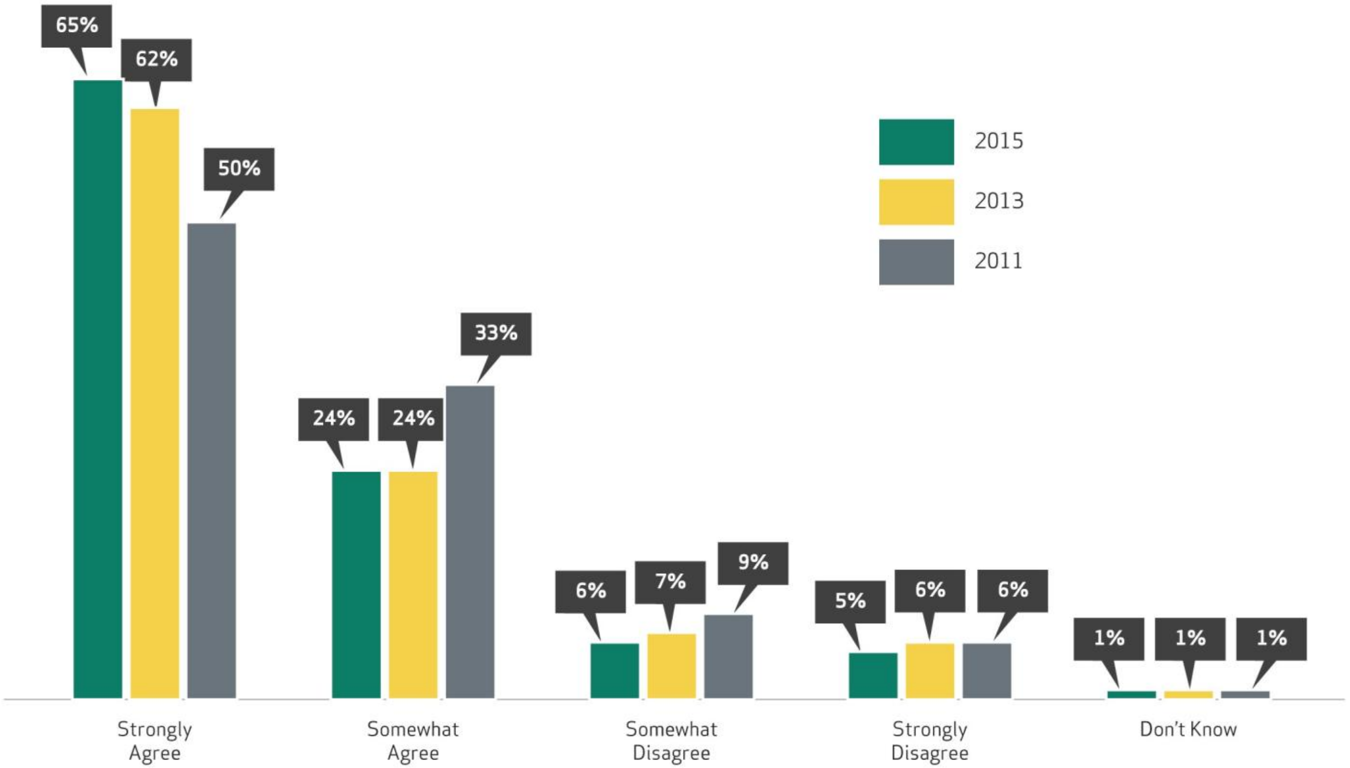
Given that they fund a significant portion of their own pensions, how strongly do you support or oppose giving pensions to local firefighters, police, and municipal employees?



88 Percent Of Americans Support Public Pensions For Police, Fire

Figure 25: **88 Percent Say That Police Officers and Firefighters Deserve a Secure Retirement With a Pension Because of Their Risky Jobs**

Please tell me whether you agree or disagree that police and firefighters have agreed to take jobs that involve risks and therefore deserve pensions that will afford them a secure retirement.



88 Percent Of Americans Support Public Pensions For Police, Fire

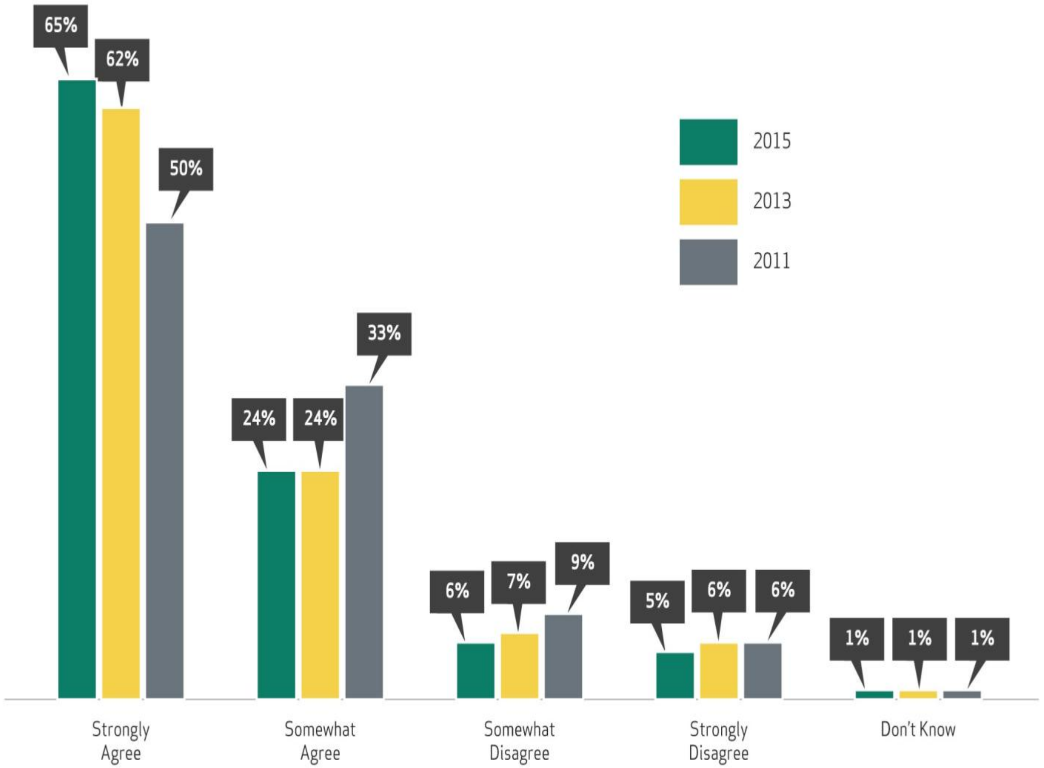
TEXANS:

68% Strongly Agree

92% Total Agree

Figure 25: **88 Percent Say That Police Officers and Firefighters Deserve a Secure Retirement With a Pension Because of Their Risky Jobs**

Please tell me whether you agree or disagree that police and firefighters have agreed to take jobs that involve risks and therefore deserve pensions that will afford them a secure retirement.



Conclusions DB Format Retained

- DB plans have built-in economic efficiencies – provide a “better bang for the buck.”
- DB pensions help attract and retain workers and increase productivity and are highly valued.
- Decision makers should continue to carefully evaluate claims that “DC plans will save money”and reduce underfunding.
- Public support for pension is favorable.

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Questions?

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