Retirement and Benefits for the Generations

By Valerie Martin Conley

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State legislatures addressed a plethora of topics related to retirement and benefits in 2010. An aging population, the sluggish economy, regulatory requirements, and increased scrutiny of public pension plans explain the flurry of activity. Lawmakers debated contribution rates and funding issues; cost of living adjustments; defined benefit plan changes; defined contribution and hybrid plans; divestment; governance and investment policy; health coverage; legislative process; military service; re-employment after retirement; early retirement incentives; retirement programs for elected officials; ethics; forfeiture of benefits; privacy; contribution returns, and Social Security.[1] This topical breadth denotes the complexities surrounding today's retirement issues.

The dimensions of the problem: Policy makers in California—a bellwether for the rest of the nation—found that the California Public Employees' Retirement System needed an estimated $600 million more than the state's current fiscal year contribution of $3.3 billion. Investment losses had resulted in a 24 percent decline ($217 million) in the 12 months preceding June 30, 2009. The system needed an additional $299 million because retirees are living longer and retiring earlier.

The president of the University of California System convened a Task Force on Post-Employment Benefits to recommend strategies for closing an estimated $21 billion gap in the university's retirement fund. The gap stems from a decision made 20 years ago to stop university and employee contributions. The final report, released July 2010, recommended increasing the retirement age for new employees, increasing university and employee contributions, and reducing benefits. The task force Pension Work Team recommended a "New Tier" for employees hired after July 2013; offering current employees the current retirement plan at a higher cost or the new plan for future service (pending IRS approval), and a more rapid increase in university and member contributions. The Retiree Health Work Team recommended adoption of an age-times-service credit formula, and monitoring health care reform. The Finance Work Team recommended amortizing gains and losses over 30 years instead of 15, and restructuring debt.

All parties agreed a solution was needed. Attempting to make up for lost ground, the system began requiring employer (four percent) and individual (two percent) contributions immediately, with shares increasing to ten percent and five percent, respectively, by 2012. But questions remain regarding some proposed strategies for closing the gap. Task force members, faculty, and unions worried about the system's ability to attract and retain academic talent. Others raised concerns about equity in the one-size-fits-all approach. The proposed changes in benefits and contributions levels would hit lower-income workers especially hard—particularly absent salary increases to offset the changes.

New employees may receive a less generous package. The California Board of Regents increased the standard retirement age from 60 to 65 and the early retirement age from 50 to 55. The choice: wait longer to claim the full benefit or receive a reduced benefit for fewer years. The Regents also voted to decrease its share of retiree health care costs from 89 percent to 70 percent by 2018. Some unions, in contrast, are calling for a higher share of covered health care costs—especially for lower paid employees—in pending contract negotiations.

Other states addressed similar problems by enacting legislation related to contribution rates and funding. The Illinois legislature, for example, extended the deadline for the retirement system to reach 90 percent of funding from 2045 to 2059. What follows are some more detailed examples.

IOWA

Enacted changes to the Iowa Public Employees Retirement System (IPERS) affect vesting, benefits calculations, and benefits levels for employees who retire prior to normal retirement age. This retirement age increases from age 55 to 65 regardless of years of employment, effective July 1, 2012. The vesting requirement increases from four to seven years on the same date. IPERS will base retirement benefits on the highest five years of salary, up from the highest three years. This provision affects all employees, but a transitional calculation applies to individuals vested before the effective date.

Transitional calculations are important for mid-career employees. Iowa exempts most employees nearing retirement—the group receiving the most attention when legislatures contemplate changes. New, younger employees have more time to adjust to changes in the system. But mid-career employees will not accrue long-term savings returns.

The new law reduces benefits to IPERS participants retiring prior to age 65—the new normal retirement age—by six percent for each year they receive a retirement allowance. The old law reduced the allowance by 0.25 percent per month, or three percent per year, for each year they received a benefit prior to age 55. Last year, the University of Iowa temporarily decreased its contributions to retirement plans—part of a response to a ten percent reduction in state appropriations. The temporary reduction expires on June 30, 2011. These decisions lengthen the time Iowa employees must work to qualify for the same or similar retirement benefits.

MICHIGAN

Michigan was the first state to switch to a defined contribution plan for its general employees.[2] Act 75 of 2010 (SB 1227) requires all newly hired school employees to enroll in a hybrid defined benefit-defined contribution system. The hybrid plan eliminates cost of living adjustments to pension allowances. The minimum retirement age increased from 55 (existing defined benefit plans for school employees in the state) to 60 (hybrid plan) with ten years of service.

The legislation also required all participants in the Michigan Public Schools Employees' Retirement System to contribute three percent of compensation, held in trust, to pay for health care benefits for retirees and their eligible dependents. Employees earning less than $18,000 received a slight reprieve: a required 1.5 percent contribution for FY 2010–11, and three percent subsequently. Plaintiffs in a lawsuit allege the new employee contributions violate the union contract, and contributions are in escrow until the case is resolved. Michigan, like Iowa, adjusted the benefits calculation to base final average compensation (FAC) in the hybrid plan on five years instead of three. The plan prohibits the purchase of service credit to meet service requirements.

Act 75 also included an early retirement incentive and a re-employment provision. The one-year window provided a 1.6 percent multiplier in the pension formula for employees eligible to retire, and a 1.55 percent multiplier for employees meeting a combined age and years of service threshold of 80. The incentive—estimated to yield $670 million in savings if accepted by half of the 55,000 eligible employees—saved about $515 million when more than 17,000 individuals signed up.

The re-employment provision suspends pension and health care benefits for employees who retire after July 1, 2010 and are re-employed as independent contractors or by a third party to provide core services. One exception: retirees who are re-employed directly may maintain pension and health benefits if they earn less than one-third of their final average compensation.

EMERGING TRENDS IN FINANCING

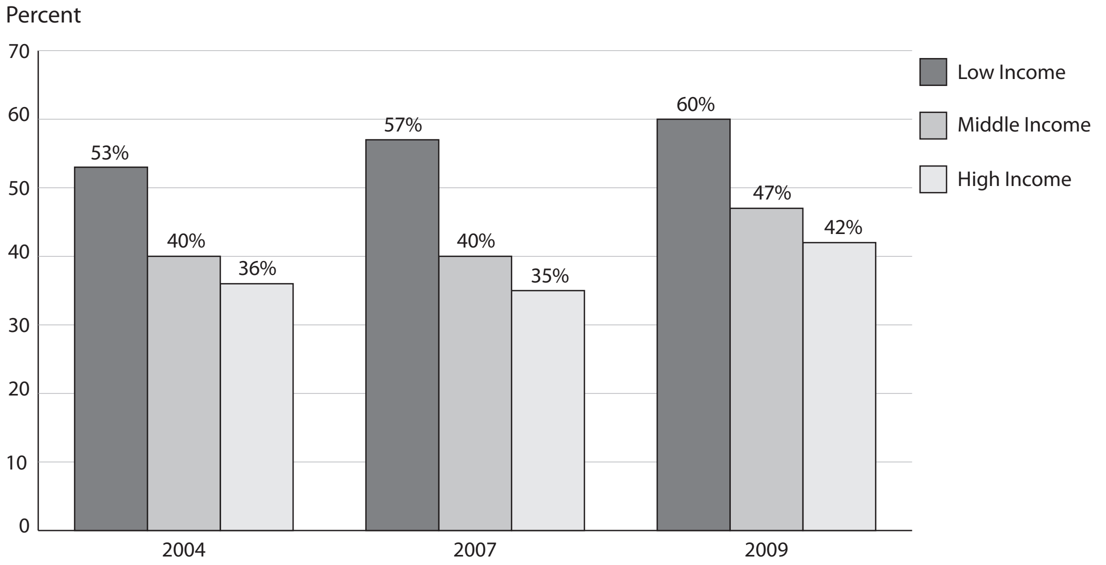
Researchers identify healthcare cuts and reduced retirement benefits as key strategies for balancing the budgets of research universities.[3] Many higher education employees will therefore work longer for lower retirement benefits.

The National Retirement Risk Index (NRRI) "measures the share of American households who are 'at risk' of being unable to maintain their pre-retirement standard of living in retirement."[4] "Even if households work to age 65 and annuitize all their financial assets, including the receipts from reverse mortgages on their homes," note the NRRI statisticians, "in 2004 43 percent would have been 'at risk' of being unable to maintain their standard of living in retirement."[5] The proportion of households "at risk," as measured by the NRRI, increased by only one percentage point between 2004 and 2007 (from 43 to 44 percent).[6] But researchers then projected the NRRI using data from the second quarter of 2009, after the economic crisis took hold. The proportion of households "at risk" at age 65 in 2009 increased to 51 percent. Figure 1 shows the percent of households "at risk" at age 65 by income group.

Figure 2 shows the percent of households "at risk" at age 65 by age cohort in the same three years. The percent of households "at risk" at age 65 in 2009: Early Boomers (41 percent), Late Boomers (48 percent), and Gen Xers (56 percent).

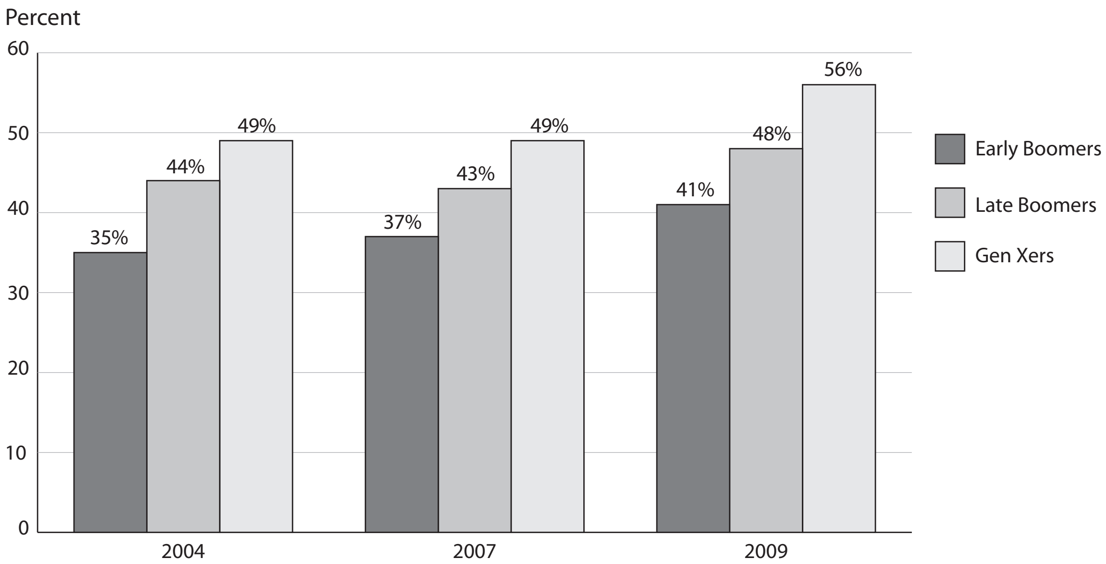
These conservative estimates assume that households derive the maximum possible income from the assets they hold at retirement.[7] "Ensuring retirement security for an aging population is one of the most compelling challenges facing the nation," note the researchers. "The outlook will get worse over time."[8] The problem

Figure 1. Percent of Households "At Risk" at Age 65 by Income Group, 2004, 2007, and 2009



Source: Center for Retirement Research at Boston College, October 2009.

Figure 2. Percent of Households "At Risk" at Age 65 by Cohort, 2004, 2007, and 2009



Source: Center for Retirement Research at Boston College, October 2009.

arises from the changing retirement income landscape: declining equity values, fading defined benefit plans and stagnating pension coverage, bursting of the real estate bubble, and the decreasing portion of pre-retirement earnings that Social Security will replace as the full retirement age increases from 65 to 67 years.[9]

RETIREE HEALTH PLANS

Lower salaries and more generous benefits differentiate public sector employment from working in the private sector. Health plans, in particular, are an important element of public sector retirement benefits and total compensation. These plans represent "a promise to provide future income in exchange for work today."[10] But this promise also represents a significant cost to public employers and taxpayers.

Changes in reporting requirements for liabilities associated with retiree health benefits have increased awareness of the cost of this insurance. The cost of retiree health insurance was treated as an annual expense before Governmental Accounting Standards Board (GASB) Statement 45 was issued in 2004. GASB 45 required public employers to estimate the liabilities for all post-employment benefits by the methods used to calculate pension obligations. States must "report the present discounted value of the future liability of heath care promises to current workers as these benefits are accrued, along with the present value of these promises to current retirees."[11] The GASB 45 actuarial reports thus reveal the real cost of the benefits.

Researchers who studied GASB 45 actuarial reports from the 50 states over the past three years concluded "that some states have large and growing unfunded liabilities and the annual cost of providing health care to retirees is growing rapidly."[12] Perhaps their most significant finding: striking variation across states.

> Some states have large unfunded liabilities associated with retiree health insurance and rising pay-as-you-go cost of maintaining the relatively generous health plans. In contrast, other states are not facing a funding crisis. Instead, their unfunded liabilities are small and manageable and they have greater control over the annual cost of their retiree health plans.[13]

The key parameters vary by state: age and years of service required for plan eligibility, the proportion of the premium paid by the state, and the relationship between the plans and Medicare.

> The primary difference in these plans is the level of subsidy or the generosity of the plans. Some states provide health insurance to retirees at no cost while other states require the retiree to pay the entire premium for health coverage. This difference in the generosity of the plans across the states is much greater than the difference in pay for similar jobs or in the pension benefit provided to public employees.[14]

Detailed descriptions of state retiree health plans illustrate the differences.

> For example, in California the state pays 100 percent of the premium for all employees hired before 1985. For employees hired between 1985 and 1989, the state contributes 10 percent of the premium for each year of service. Thus, workers with 10 years or more of service pay no premium for the health insurance. For employees hired after 1989, the state pays 50 percent of the premium for retirees with at least 10 years of service. Each additional year of service beyond 10 increases the state subsidy by 5 percent, so that for workers with 20 years of service, the state pays the entire premium.[15]

Vesting schedules for Hawaii employees also depend on their date of hire:

> For a retiree hired prior to July 1, 1996 and retired after June 30, 1984, with less than

> 10 years of service, the state contributes 50 percent of the premium; for those with 10 or more years of creditable service, the state makes a 100 percent contribution. For retirees hired after July 1, 1996, with 10–15 years of service, the state pays 50 percent; with 15–25 years, the state contributes 75 percent; and for those with at least 25 years of service, the state pays 100 percent of the premium.[16]

In Illinois, the premium paid depends upon the plan chosen, years of creditable service, and Medicare status. Retirees receive a five percent state contribution for each year of creditable service.

In Iowa:

> All retirees who participate in the health plan can continue to receive coverage for the rest of their lives. However, if a retiree does not elect coverage, or lets coverage lapse in any way, they are not eligible for re-enrollment in the plan.... Upon turning 65 years of age, all retirees are required to enroll in Medicare Parts A and B; at which point, Medicare becomes the primary insurance provider and the state-offered health insurance plan becomes the secondary payer.
>
> To pay for retiree health insurance benefits, those not eligible for Medicare may be eligible for participation in the Sick Leave Insurance Program (SLIP). SLIP allows retirees to convert their unused sick time into an account that the state will draw down to apply to the retiree's health insurance premium. For retirees participating in SLIP, the state continues to pay their portion of the premium until their account is exhausted, or they become Medicare eligible, return to work, or leave the plan for any reason.[17]

Michigan "retirees who are not Medicare eligible can receive health insurance benefits if they retired under the state's Defined Benefit Contribution Pension Plan, receive an immediate pension under the State Employees' Retirement Act or the State Police Retirement Act, or were previously enrolled in a state-sponsored HMO and receive an immediate pension benefit."[18]

Minnesota retirees are responsible for the full premium; the state makes no contribution. Retirees who are ineligible for Medicare pay $447.28. Individual coverage for Medicare eligible retirees ranges from $247.00 to $301.91.[19]

Plan details also vary in complexity.

> Pennsylvania provides retiree health insurance to retirees who retire at normal retirement age (50 or 60, depending on class of employment) with 15 or more years of credited service; who retire with 25 or more years of service regardless of age; or who retire with a disability retirement benefit….
>
> The state's premium contribution depends on date of retirement and is based on the retiree's final base annual salary. For those who retire: before July 1, 2005, the state subsidy is 100 percent of the premium; after July 1, 2005 but before July 1, 2007, the State Employee Retirement System will deduct the member share of 1 percent of the member's final base annual salary in equal monthly payments from the member's annuity payments; after July 1, 2007 but before June 30, 2008, the State Employee Retirement System will deduct the member share of 1 percent of the member's final gross base annual salary in equal monthly payments from the member's annuity payments; after July 1, 2008 but before June 30, 2009, the State Employee Retirement System will deduct the member share of 1.5 percent of the member's final gross base annual salary in equal monthly payments from the member's annuity payments; after July 1, 2009 but before June 30, 2010, the State Employee Retirement System will deduct the member share of 2 percent of the

> member's final gross base annual salary in equal monthly payments from the member's annuity payments.[20]

These descriptions reveal the extent of reduced benefits for younger workers. But they tell only of promises made to employees and retirees. The actuarial reports discuss the ability of states to pay for these promises. Interpreting the actuarial reports requires understanding key concepts:

> Key concepts reported in the states include actuarial accrued liabilities (AAL), the unfunded actuarial accrued liabilities (UAAL), and the annual required contribution (ARC). The UAAL is the difference between the AAL and any assets that the employer has set aside in an irrevocable trust. If the plan is completely pay-as-you-go, the UAAL is equal to the AAL because there are no assets…
>
> The ARC is the normal cost as calculated by the actuary plus the amount needed to amortize the existing unfunded liability over a 30-year period. The normal cost is the portion of the present value of benefits that is allocated to the current fiscal year of active employees. ARCs and UAALs have been growing over time in most states and are now a major public policy issue for many states.[21]

GASB 45 does not require states to pre-fund plans or to establish trust funds, but some states do have trust funds. Ohio's trust fund, the largest, has approximately $12 billion in assets. Other states recently enacted, or are discussing, trust fund legislation for their retiree medical plans.[22]

The ability to offer retiree health insurance is an important benefit. But policy makers must contend with rapidly increasing costs of retiree health plans and the associated unfunded liabilities, while legislatures wish to reduce these costs and liabilities. The key strategies: increasing the years of service needed to receive the full subsidy, increasing the employee share of the cost, altering benefits, and promoting wellness programs.[23]

Changes are typically imposed on future hires. Rarely, if ever, do changes apply to current employees. The reason: "Exempting current employees from changes in the eligibility conditions has little or no immediate impact on the cost of these plans and only a small effect on the long term liabilities," note the researchers. "Adopting these reductions in benefits without including current employees is more easily accomplished by state policy makers."[24]

These challenges will continue as annual health plan costs command a larger proportion of state budgets.

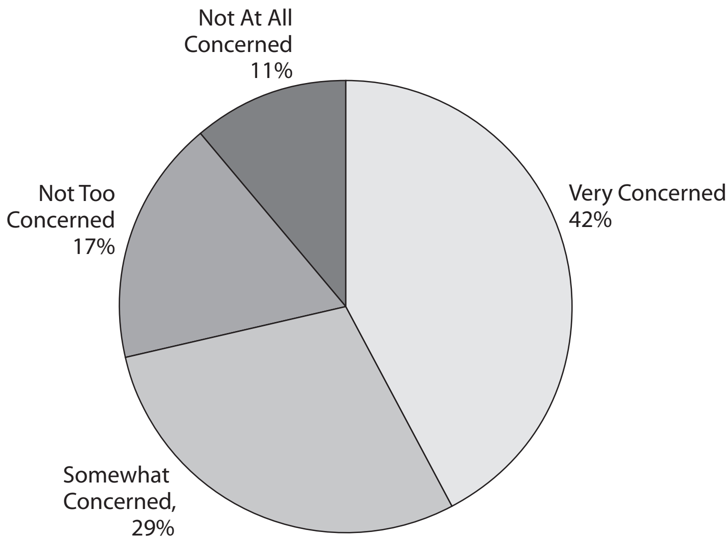
RETIREMENT CONFIDENCE

How ready are near-retirees to meet health care expenses in retirement? Figure 3 shows near-retirees are concerned about their ability to afford good health care in retirement: the majority of higher education employees nearing retirement (71 percent) were either "very concerned" (42 percent) or "somewhat concerned" (29 percent).

About one-third of near-retirees did not know how much they should expect to pay for retiree health insurance. The actual amount averages around $10,000 out-of-pocket annually, but 34 percent answered less than $5,000. Individuals who feel inadequately prepared to meet health care expenses are likely to delay retirement. "Any changes to employer-sponsored retiree health benefits designed to control expenditures should consider the potential for unintended consequences regarding actual decisions to retire."[25]

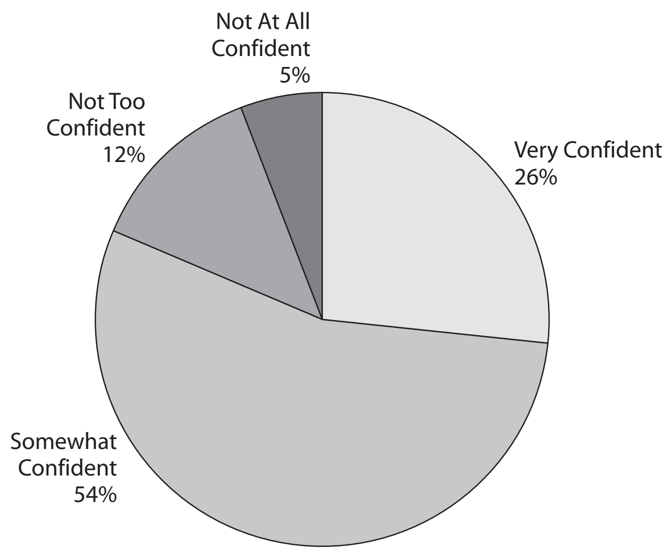
Still, higher education employees are more confident in their prospects for a financially secure retirement than most Americans: 26 percent of higher education employees are "very confident," and 54 percent are "somewhat confident."[26] Figures 4 and 5 show the

Figure 3. Concern About Ability to Afford Good Health Care in Retirement, All Higher Education Employees, 2009



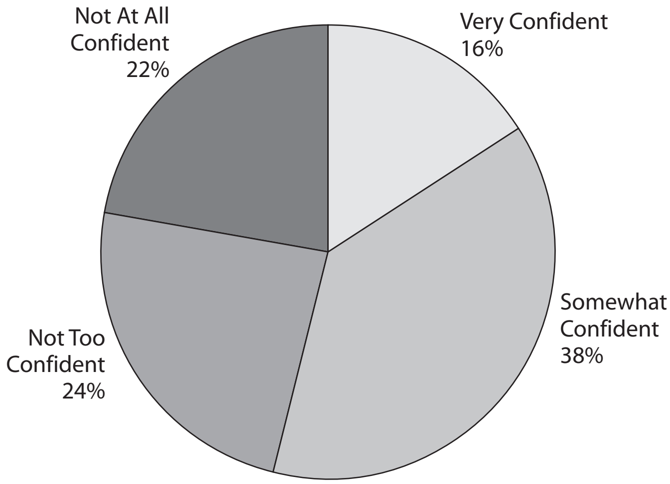
Source: Yakoboski, December 2009.

Figure 4. Percentage Distribution of Retirement Confidence, All Higher Education Employees, 2010



Source: Yakoboski, June 2010.

Figure 5. Percentage Distribution of Retirement Confidence, All U.S. Workers, 2010



Source: Yakoboski, June 2010.

percentage distribution of retirement confidence for higher education employees and for U.S. workers, respectively.

VENDOR ACCESS

A recent study concluded that improvements in administrative oversight models for public K–12 supplemental 403(b) plans could improve retirement outcomes. "Providers in open access states," the researchers found, "assess a wider variety of fees and charge significantly higher fees relative to providers in controlled access states."[27] High fees adversely affect wealth accumulation.

Negotiators confront a continued shift from defined benefit to defined contribution or to hybrid plans in the public sector. They must develop a savvy understanding of different types of pension plans and the extent to which these plans meet the needs of a diverse workforce. Union leaders should monitor administrative oversight of defined contribution plans, and should know the key concepts in actuarial reports: AAL, UAAL, and ARC.

CONCLUSION

This essay summarized legislative actions related to retirement and benefits and described retiree health plans in selected states. It then reviewed the retirement income landscape for the general population and higher education employees. There are significant challenges ahead. Negotiators must consider the need for intergenerational programs, and identify plan characteristics that benefit all employees.

NOTES

1 The National Conference of State Legislatures (NCSL) digests selected state pension and retirement legislation to show how other states handled these issues.

2 Center for Retirement Research at Boston College, 2009.

3 The 2009 annual meeting of the National Association of College and University Business Officers (NACUBO) discussed these strategies (Stripling, 2009).

4 Munnell, Webb, and Golub-Sass, 2009, 1.

5 The researchers based their calculations on the Federal Reserve's *2004 Survey of Consumer Finances* (Federal Reserve Bank, 2006).

[6] The researchers based this update on the Federal Reserve's *2007 Survey of Consumer Finances* (Federal Reserve Bank, 2009).

[7] Center for Retirement Research at Boston College, 2010.

[8] Munnell, Webb, and Golub-Sass, 2009, 7.

[9] Other NRRI results and related publications are available at http://bit.ly/4FRG8a.

[10] Clark and Morrill, 2010, 1.

[11] Ibid., 6.

[12] Ibid., 7.

[13] Ibid., 9.

[14] Ibid., 29.

[15] Ibid., 28.

[16] Ibid., 36-37.

[17] Ibid., 39.

[18] Ibid., 43.

[19] Ibid., 44.

[20] Ibid., 54-55.

[21] Ibid., 7.

[22] Ibid., 8.

[23] Ibid., 9.

[24] Ibid., 28.

[25] Yakoboski, 2010, 7.

[26] Results are from Yakoboski, 2010.

[27] Clark and Richardson, 2010, 10.

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