

Protecting the Retirement Security of NEA Members



A Toolkit

NEA Collective Bargaining

& Member Advocacy

202.822.7080



Great Public Schools for Every Child

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Great Public Schools for Every Child

The National Education Association is the nation's largest professional employee organization, representing 2.7 million elementary and secondary teachers, higher education faculty, education support professionals, school administrators, retired educators, and students preparing to become teachers.

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WHAT IS IN THE KIT?

1. Primer

A guide to help Associate leaders, staff and members:

- ▶ Describe the advantages of DB pension plans and the ways DB plans contribute to retirement security.
- ▶ Be familiar with the weaknesses of DC plans and the arguments used to promote them.
- ▶ Understand the experiences of states that have adopted DC plans for their public pension funds or have proposed legislation to do so in the past.
- ▶ Be aware of the threats to DB plans and why they are under attack.
- ▶ Plan to defend both the defined benefit plan structure and the quality and level of benefits that DB plans presently provide.

2. Glossary

This glossary provides standard definitions for pension terms.

3. Frequently asked questions

This section answers frequently asked questions about defined benefit and defined contribution pension plans.

4. Developing an action plan

This step-by-step guide outlines suggestions for conducting effective campaigns around pension issues, drawn from the experiences of NEA affiliates. It is designed to help the state and local affiliates plan their strategy, build their case, activate members, reach out to the public, and educate elected officials about the merits of defined benefit pension plans.

5. NEA resolutions

This section lays out the resolutions concerning pension issues approved by the NEA Representative Assembly.

6. Questions for investment managers

All else being equal on investment performance, pension trustees may consider other collateral issues in evaluating investment managers. This tool lists questions to ask investment managers.

7. Research findings

This section summarizes studies, reports and articles that address issues pertaining to converting defined benefit pension plans to defined contribution plans.

8. Additional resources

This list details public web sites that contain useful information for promoting and defending defined benefit retirement plans.

9. Myths & misperceptions

This white paper was prepared by the National Association of State Retirement System Administrators (NASRA) to address some of the more common myths and misperceptions involved in efforts to replace defined benefit pension plans with defined contribution plans.

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FOREWORD

Defined benefit pension plans offer Association members a secure retirement by providing a guaranteed benefit that can never be taken away. Such plans are the primary retirement benefit for over 90 percent of K-12 public school teachers and education support professionals and for most other public employees.

Unfortunately, defined benefit plans are under attack. During the past decade, various groups with a financial or political interest have worked to eliminate defined benefit plans that are provided to public employees and replace them with defined contribution plans, which are not guaranteed. In order to respond to such efforts, it is essential that we understand the importance of defined benefit pension plans versus defined contribution plans for retirement security.

This kit is intended to provide Association staff, leaders and members with tools to defend against attacks on public school defined benefit pension plans and fight off defined contribution plans.

I am sure that you will find this information both useful and informative, and I believe it will help you defend and strengthen the retirement security of NEA members.

Reg Weaver
President
National Education Association

INTRODUCTION

The mainstay of a financially secure retirement for public school teachers, education support professionals, and other public employees has traditionally been the defined benefit (DB) plan. Periodically in recent years, public officials, state legislators, and others with a financial or political interest have promoted dropping public employees' DB plans in favor of defined contribution (DC) plans. While DC plans can be a useful adjunct to a sound DB plan, they cannot effectively replace the security of a traditional retirement plan. DC plans do not provide predictable benefits or guarantee a financially secure retirement. While few public employers have abandoned their DB plans, economic conditions have increased pension funding pressures. DC plan proponents are seeking to exploit this situation by advocating and lobbying for wholesale conversion of DB plans to DC plans to reduce costs.

This primer and attachments were produced to assist state affiliates defend against attacks on public school defined benefit pension plans and fight off defined contribution plans. The kit examines the ways in which DB plans contribute to retirement security for K-12 public education employees. It also analyzes the problems with DC plans and the specious arguments used to promote them. Finally, this toolkit outlines an agenda for defending both the defined benefit plan structure and the quality and level of benefits that plans presently provide.

THE BASICS

Defined Benefits vs. Defined Contribution

Defined benefit (DB) plans are the primary retirement plan for most teachers and education support professionals (ESPs) in the United States. Many public school employees also have a voluntary defined contribution (DC) plan available to them.

A DB plan provides a benefit based on an individual's years of service, multiplied by his/her final average salary, and then multiplied by some percentage (usually between 1.5 and 2 percent) (Fundamentals of Employee Benefit Programs for Education Employees,) a NEA-Sponsored Publication, prepared by the Employee Benefits Research Institute [EBRI], 1996).

A DC plan is an account in which contributions are invested and earn income. When a DC plan participant retires, the amount in the account represents his/her retirement income. The participant can opt to gradually withdraw or take the money out at one time, known as a lump sum.

Retirement Systems with Defined Benefit Plans

Although DB plans are the primary retirement benefit for most K-12 teachers and ESPs, the structure of the plans varies from state to state. In some states, the structure is a "pure" DB plan, which provides a benefit based on a formula and has no features that relate to a DC plan. Examples of such systems are the Georgia Teachers Retirement System, the Massachusetts Teachers' Retirement System, the Pennsylvania Public School Employees' Retirement System and the New Mexico Educational Retirement Board.

Retirement Systems with Defined Contribution Plans

Public employers often provide employees with voluntary supplemental DC options as an adjunct to their guaranteed DB plan. Some statewide public employee retirement systems require certain types of government employees to participate in a DC plan. West Virginia, however, is the only state that requires teachers and ESPs to participate in a DC plan as their primary retirement benefit. The state created a DC plan that covers any teacher or ESP hired on or after July 1, 1991. Teachers and ESPs hired before then are in a DB plan.

Retirement Systems with Hybrid Plans

In addition to traditional DB and DC plans, several states have developed hybrid plans that include features of both DB and DC plans. There are a variety of ways that states have modified DB plans to add some of the elements of DC plans.

In some states, the employer's contributions fund a DB plan and the employees' contributions fund a DC plan. When employees retire, they receive two streams of income, one from the DB plan and the other from the DC plan. Washington State provides such a plan for individuals eligible for Teachers' Retirement System Plan 3 and ESPs eligible for School Employees Retirement System Plan 3. In Oregon, individuals hired on or after August 29, 2003, are in a similar plan to Washington's Plan 3, called the Oregon Public Service Retirement Plan.

In other states, the retirement benefit is a DB plan, but the employees may be eligible for a benefit under either the DB plan or a "money purchase plan." The Wisconsin Retirement System (WRS) calculates its members' benefits using two separate methods: formula and money purchase. The formula method is a typical DB plan calculation. The money purchase method uses the employee and matching employer deposits in the member's account multiplied by an actuarial money purchase factor based on the member's age when the annuity begins. Both the formula method and the money purchase benefit result in a monthly benefit. WRS calculates the benefit both ways and pays the member the higher amount.

The Colorado Public Employees' Retirement Association (PERA) performs a similar calculation for its members. It looks at a member's benefit under the DB formula. Then it makes a calculation using a money purchase benefit that has three factors: 1) the member's life expectancy; 2) the value of the member's account (his/her contributions and interest); and 3) a matching amount equal to 100 percent of the amount in the member's account. The member's benefit is equal to the higher of either the DB benefit or the money purchase benefit.

Why defined benefit plans provide retirement security

The Funding of DB Plans is Designed to Ensure Sufficient Assets to Pay Promised Benefits

DB plans are generally reserve funded, rather than pay as you go. Under reserve funding, assets are paid into the plan over time to ensure sufficient funds are available for promised benefits. Under pay as you go, funding is appropriated each year to pay benefits.

Three sources provide funding for the plans. First, the state, school districts, or both contribute to the plan. Second, the teachers and ESPs usually contribute. In the private sector, employee contributions to a DB plan are rare. Third, the

contributions themselves, which are managed by professional investment managers, provide income. The contributions and income are held in a trust fund that is separate from the assets of the sponsoring government.

DB Plan Benefits are Guaranteed

The laws of state and local governments guarantee retirement benefits under a DB plan. Thus, benefits cannot be reduced or eliminated. The source of the guarantee varies. In some states, the guarantee is in the constitution. Other states provide it in a statute, and still others have developed it through the judicial system. DC plans typically provide no protection. Even the most generous employer contribution to a DC plan can be eroded because of poor investment returns.

DB Plans Do Not Place Investment Risk on the Participant

A fundamental difference between DB and DC plans is the question of who bears the risk if the contributions to a retirement plan are insufficient. Under a DB plan, benefit levels are set but contribution levels needed to fund those benefits are not predictable over the long term. Based on periodic evaluations, contribution levels are set at a level that is deemed adequate to pay the promised benefits.

If an individual in a DC plan faces insufficiency, he/she will have inadequate income during retirement. In a DC plan, the employee bears all the risk.

While there is also a risk of loss due to poor investment performance in DB plans, and both employers and employees in the public sector usually contribute to the plan, it is the employer who ultimately bears the risks.

Pension funds invest assets with an optimum mix of growth potential and risk. Studies show that individuals responsible for their own retirement income typically invest too conservatively, and thus may not adequately protect their retirement benefits from inflation. Because of their size, DB plans have the financial ability and knowledge to hire expert advisors.

DB Plans are Governed by Trustees and Staff who, as Fiduciaries, are Subject to a Strict Set of Laws

Boards of trustees govern most DB plans for teachers and ESPs. The boards establish overall policy for the administration of the plan. An executive director and staff are responsible for the daily administration of the plan. Board members may include representatives of employees, retirees, and employers. In most states, certain state officials, such as the state treasurer, sit on the board. In some states, members of the public or individuals with special skills, such as investment expertise, are also members.

The board members and top staff of the retirement plan are subject to a set of fiduciary duties. These duties require them to act for the exclusive benefit of the

participants and beneficiaries of the plan. Their duties include prudently hiring professionals to invest the assets of the plan.

Teachers and ESPs May Make Tax-Deferred Contributions into Voluntary DC Plans

The DC plans available to teachers and ESPs are generally tax-sheltered annuities, sometimes known as Section 403(b) annuities, after their location in the federal Internal Revenue Code. Non-educational public employees have similar savings vehicles called deferred compensation plans, sometimes known as Section 457 plans, after their location in the code. The comparable retirement savings vehicle for private-sector workers is the 401(k) plan (also so-named because of its code location). A few public employees have 401(k)s, but coverage is limited because the right of state and local governments to offer such plans ended under the Tax Reform Act of 1986.

Teachers and ESPs can voluntarily supplement their retirement savings through 403(b)s. The money they contribute is deferred from tax until they retire and withdraw it. The 403(b) serves as a complement, though not a replacement, for a DB plan.

DB AND DC: BENEFITS & DISADVANTAGES

Comparison of Defined Benefit and Defined Contribution Plan Features

Feature	DB Plans	DC Plans
Guaranteed benefit	YES	NO
Employer bears investment risk	YES	NO
Benefit predictable	YES	NO
Professional investment	YES	Only if plan participant hires someone
Early retirement features	YES	NO
Early Retirement Incentive Programs (ERIPs)	YES	NO
Disability features	YES	NO
Minimum death benefit	YES	NO
Benefit improvements	YES	NO
COLAs	YES	NO
Portability	YES through purchases of service credit and other features	YES
Low expenses	YES	NO
Negotiating power over fees	YES	NO
Reward and encourage longevity	YES	NO

DB Plans Provide a Defined, Guaranteed, Predictable Benefit

In a DB pension plan, the pension benefit to be provided at retirement is defined, while the contributions to be made over the period of employment are variable based on the experience of the pension fund. The retirement benefit is determined by a formula. The

formula is normally calculated as a percentage of an employee's salary, usually earned shortly before retirement, and is based on years of service and a multiplier factor. While the definition of final average salary and the multiplier factor differ from plan to plan, the basic formula typically looks like this:

$$(\text{years of service}) \times (\text{final average salary}) \times (\text{multiplier}) = \text{Annual Pension Benefit}$$

The formula allows employees to enter their particular data and estimate the exact benefit that they can expect upon retiring. Because of their predictability, DB plans make retirement planning easier.

A DC plan consists of an individual account, which is funded, depending on its design, by employers, employees, or both. The contributions are invested and earn income. The benefit payable to the employee at retirement is the amount of money accumulated in his/her account. The amount of funds available is not known until the individual reaches retirement.

A Wall Street Journal article graphically compared the predictability of a DB plan with a DC plan. Drew O'Connor and Michael Lassandrello are cousins who both live in Naperville, Illinois. They grew up near each other in the south side of Chicago. They are nearly the same age and have always been close. Their careers diverged widely, however. Drew works for the Illinois Department of Revenue. He joined the department as an \$18,000-a-year special agent. He wasn't able to save much, but he succeeded in rising through the ranks of the department to become a senior special agent, earning \$72,000 per year. Michael's career path took him to a succession of telecom companies where he worked as an engineering manager.

Drew is a member of the Illinois retirement system for state employees, a DB plan. He will receive a guaranteed benefit based on his years of service and final average salary. As part of a special incentive, Drew will take an early retirement this year. The incentive allows him to leave with full pension benefits at 51 instead of the usual 55. He estimates that his annual pension will be \$54,000.

Michael had a 401(k) plan at his company, which laid him off in 2002. When the stock market took off, he expected a far more generous retirement than his cousin would receive. In the aftermath of the boom, his retirement savings sank 30 percent. If he stopped working now—as his cousin will soon do—and wanted to make sure he wouldn't outlive his money, he could draw just \$28,000 a year (John Hechinger, "Market's Swoon Boosts Pensions Over 401(k) Plans," *Wall Street Journal*, August 16, 2002).

DB Plans are Comprehensive

Most DB plans provide comprehensive benefits, which often include early retirement, disability, cost of living adjustments, retiree health coverage, and death benefits. Most DC plans do not provide such benefits.

Early Retirement Benefits

A DB plan usually provides more than just normal retirement benefits. Most public-sector DB plans offer an early retirement feature based on the normal retirement benefit to which a reduction factor is applied. The most common early retirement requirements are age and length of service. Alternatively, some employers offer an early retirement incentive program (ERIP) with an unreduced benefit. In that case, the employer may fund the ERIP with excess assets in the DB plan. DC plans never have excess assets to fund an ERIP.

Disability Protection

DB plans are designed to share risk, so disability coverage can easily be built into the total retirement program. Usually those DB participants receiving payments under this type of program are "retired" and will be paid as long as they are disabled, without respect to age. Under a DC plan, risk cannot be shared, so a disability program cannot be offered. Instead, a DC plan participant who becomes disabled and is unable to work will have access only to what money has accrued in his/her account.

Death Benefits

Death benefits are another frequent feature of DB plans. The benefit can be provided under a formula and can require that some minimum amount be paid to the beneficiary even if the deceased member's benefit is small. Under a DC plan, the death benefit depends solely on the account balance, so no minimum benefit can be established.

Benefit Improvements

A well-funded, mature DB plan can pay for improvements in the benefit formula through favorable actuarial experience. In the 1990s, for example, higher-than-expected investment returns allowed such improvements. In a DC plan, by contrast, the only way to increase benefits is to increase the account balance. The increase occurs by raising employer/employee contributions and/or by higher investment returns.

Cost of Living Adjustments (COLAs)

A DB plan can provide for post-retirement adjustments, also known as cost-of-living adjustments (COLAs). A COLA provides a way to raise retirees' benefits and thereby help them offset increases in the cost of living caused by inflation. COLAs are funded either through increased employer contributions, through favorable actuarial experience, or some combination.

Most DC plans do not provide COLAs because it is difficult to incorporate the funding necessary to pay them. It may be possible to provide a COLA under a DC plan if retirees are provided a variable annuity, rather than a fixed annuity. A variable annuity will provide differing monthly annuity amounts depending on market

performance. This means that the annuity could rise in value during a strong market, but drop in value if the market is weak. Market performance is not necessarily tied to increases in the cost of living. Thus, a variable annuity does not provide retirees with the same inflation protection that retirees under a DB plan with a COLA enjoy.

Summary

Various DB plan features protect the income security of workers, not only at retirement, but also if they become disabled before retirement. The COLA adds protection for workers during their retirement. If the plan participant dies, the plan usually has a death benefit to provide income to the worker's beneficiaries. This comprehensive package of benefits offers significant advantages over a DC plan.

DB Plans Help Ensure a High Performance Workforce

Attraction and Retention

A secure DB plan that guarantees specific benefits at retirement helps attract and retain productive employees, which in turn helps produce a high performance workforce for taxpayers. DC plans do not support this goal as they lack features that reward or encourage longevity.

Healthy Turnover

DB plans also allow for healthy turnover. The plans help employees build guaranteed retirement income so they can exit the workforce. When workers are eligible to retire and feel they can afford to do so, they are comfortable leaving their positions. This outflow creates promotion opportunities for existing employees and job openings for new employees.

DC plans have no similar mechanism to facilitate the orderly transition of workers. In fact, DC plans may serve as a disincentive to retirement. If workers have inadequate funds in their DC plans, they will be forced to stay on the job.

DB Plans Address the Needs of Short-Term Employees

Overview

State and local governments provide a variety of ways to address the needs of both long-term and short-term employees. The design of most DB plans for teachers, ESPs, and other public employees is based on a formula that usually includes employees' final average compensation (usually the final three or five years). These years are generally the highest of an employee's career. Thus, this design rewards long service. DB plan design is sufficiently flexible, however, to preserve the value of the retirement benefits of short-term employees. The various approaches are discussed below.

Portability through Purchase of Service Credit

State laws generally allow teachers, ESPs, and other public employees to recover service credit for earlier years of work for which they will not earn credit in their current retirement system. These laws allow them to "purchase prior service credit," sometimes known as "buying back prior service." Typically, employees may purchase service credit for work with a previous employer that was not long enough to result in a pension benefit. Previous employers may include other state or local governments, the federal government, or even private entities.

Here's a typical example: A teacher works two years in a state that requires five years of service before he/she will be eligible, sometime in the future, for a pension. This minimum number of years is the vesting requirement. Then, the teacher moves to another state that requires him/her to work 30 years to receive a full pension. He/she works 28 years in the second state and purchases the two years of teaching in the first state, resulting in the 30 years he/she needs. If he/she did not have the right to purchase, he/she would have been required to work an additional two years.

Also, states frequently allow other types of purchases. Employees may buy service for various types of leave, including childbearing leave. Also, employees who leave a position and withdraw their pension contributions may, upon returning to the position, repay the amount representing the previous service credit. Some states allow employees to purchase an upgraded pension formula to increase their pension benefit. Finally, some states allow "non-qualified" purchases, in which the member may buy years of credit for which he/she did not work but is entitled to purchase so that he/she may retire earlier.

Purchasing prior service credit provides portability for DB plan participants. State law makes such purchases widely available and encourages such purchases through innovative ways to pay for it.

They have a variety of means to do so. In many states, teachers, ESPs and other public employees may:

- ▶ Roll over retirement funds from a prior job;
- ▶ Pay in installments;
- ▶ Use pre-tax payroll deductions; and
- ▶ Transfer funds in 403(b) and 457 plans, on a pre-tax basis

Source: Cynthia L. Moore, "Results of NCTR Portability Survey," National Council on Teacher Retirement, 1999

Shorter Vesting Periods

In the past, DB plans for teachers, ESPs, and other public employees were criticized for long vesting periods. An employee is vested when he/she acquires an irrevocable right to his/her accrued benefits under the plan, even if he/she leaves employment prior to eligibility for an immediate retirement benefit. The authors of the Wisconsin Retirement Research Committee's **2000 Comparative Study of Public Retirement Systems** remarked that a slow trend toward five-year vesting or shorter is taking place. Evidence confirms the Wisconsin statement. Full vesting occurs most frequently after five years – 57 percent of plans surveyed according to NEA's **Characteristics of 100 Large Public Pension Plans**. (Five years is the standard for private sector plans.) Thirteen percent of the plans surveyed provide for vesting in less than five years and 23 percent of the plans require 10-year vesting.

Indexing Future Retirement Benefits of Inactive Members

In addition to the broad availability of purchase of prior service credit and shorter vesting periods, states are also taking other steps to help short-term employees through DB plan design. One approach is to index the future retirement benefit of inactive retirement system members.

For example, in Colorado, the benefit of a vested inactive member with 25 or more years of service credit is indexed at the same rate as the COLA received by pension benefit recipients. Since March 2001, the rate has been 3.5 percent per year and it is compounded. The accumulated indexing occurs from the date of termination of employment to the date of retirement.

The benefit of a vested inactive member in Idaho is indexed at the same rate as the post-retirement increase of pension benefit recipients. The accumulated indexing occurs from the date of termination of employment to the date of retirement.

If a member of the South Dakota Retirement System (SDRS) terminates employment before eligibility for a retirement benefit and leaves his/her accumulated contributions in the system, his/her benefit is indexed from termination of employment until receipt of his/her retirement benefit. The indexation is 3.1 percent per year.

Plan 3 of the Washington Teachers' Retirement System increases the value of a member's benefit. Specifically, if a member separates from service with at least 20 years of service, his/her benefit is compounded at 0.25 percent per month from the time of separation to the date the retirement allowance begins. The annual rate is, therefore, slightly higher than 3 percent. The same feature applies to members in Plan 3 of the School Employees' Retirement System (which covers ESPs) and Plan 3 of the Public Employees Retirement System (which covers certain state and local government workers).

Enhanced Benefit upon Termination Before Retirement

Another way that DB plans can assist short-term employees is to allow an enhanced benefit upon termination. A member of the South Dakota Retirement System (SDRS) is entitled to receive his/her accumulated contributions under the Portable Retirement Option if he/she terminates employment before attaining three years of credited service. The accumulated contributions are the member's contributions and 75 percent of his/her employer contributions, plus credited interest. If a member leaves after three years of credited service, he/she has the choice of taking his/her accumulated contributions or keeping them in SDRS. If the member takes the accumulated contributions, he/she receives 100 percent of the employer contributions, his/her member contributions, and credited interest.

In Colorado, the legislature enhanced the benefits of short-service employees, i.e., employees who will be eligible for a benefit under the Public Employees' Retirement Association (PERA), but terminate service before reaching retirement age. Under the provision, these short-service employees have two options when they end employment. First, they can withdraw their contributions before becoming eligible for retirement, and PERA will pay them a matching amount of 50 percent of their contributions, plus interest. Second, they can leave their employee contributions with PERA until they reach retirement age and then withdraw their account and either receive a matching amount of 100 percent of their contributions, plus interest, or receive a lifetime benefit. The match is especially helpful for individuals with a fair number of years between termination and retirement.

Hybrid Plans

Several states have created hybrid plans to help short-term employees. A hybrid is a retirement plan that includes a DB component and a separate DC component. The employee is usually required to participate in both components. A hybrid plan allows an employee to take his/her DC account if he/she changes jobs. The employee may maintain the benefit under the DB plan and draw it upon reaching retirement eligibility.

Washington State adopted a hybrid for teachers, known as Teachers Retirement System Plan 3 (TRS 3). The state also adopted a hybrid for ESPs, the School Employees Retirement System Plan 3 (SERS 3). The TRS 3 applies to teachers hired on or after July 1, 1996, and SERS 3 to ESPs hired on or after September 1, 2000. The plans consist of an employer-funded DB plan with a multiplier of 1 percent. There is also an employee-funded DC plan. The contribution is mandatory, but the employee chooses a rate that must be between 5 and 15 percent.

Just recently, the governor of Oregon signed a new retirement plan into law. It is a mandatory hybrid that applies to new hires after passage of the Act. The existing and new retirement plans cover teachers and other employees. The new plan consists of a DB component with a multiplier of 1.5 percent and a DC component,

the Individual Account Program (IAP), into which employees must contribute 6 percent of their pay.

The hybrid for Ohio teachers is optional, unlike the one in Washington and Oregon. The hybrid, known as the “Combined Plan” (CP), consists of an employer contribution, which can vary year by year, and an employee contribution of 10 percent. The DB portion of the CP provides a 1 percent multiplier. The DC account provides additional funds. In addition to the Combined Plan, teachers in Ohio have the option of the traditional DB plan or a pure DC plan.

Summary of Approaches

The design of DB plans is sufficiently flexible to meet the needs of both long-term and short-term employees. Such features are not possible with DC plans.

Retirement Income Adequacy

Various studies have compared the retirement income of DB plan retirees against that of DC plan retirees. A benefit adequacy study done by the Nebraska Public Employee Retirement Systems (PERS) in 2000 raised particularly stark questions.

PERS administers three DB plans and two DC plans. The DB plans cover teachers, state patrol, and judges, respectively. One DC plan covers state employees and the other, county employees.

The DC plans came into being almost 40 years ago. Given the length of time the plans have existed, PERS had sufficient data to compare their benefits with those of the members of Nebraska’s DB plans.

Among the issues studied, PERS compared DC plan participants’ benefits with those of DB plans. It examined two issues: whether a retired state or county employee’s benefit is adequate 1) *at* retirement, and 2) *during* retirement.

PERS measured “adequacy at retirement” through comparing the benefit of a retired school employee with that of a retired state employee. For example, each is 65 years old at retirement with 30 years of service. Each has a final average salary of \$40,000. The data shows that the school employee’s retirement benefit is 55 percent of his/her final pay whereas the state employee’s benefit is only 35 percent of final pay.

The study then evaluated “adequacy *during* retirement” by looking at the COLA available to retired school employees. A school employee receives an automatic COLA of up to 2.5 percent each year. (Before 2001, the maximum was two percent.) He/she is also eligible for an additional increase to maintain his/her retirement benefit at a minimum of 75 percent of purchasing power. (When a person retires, his/her retirement benefit is at 100 percent of purchasing power. Over time, inflation erodes the value. In Nebraska, the state legislature

decided, as a policy matter, that the value of a retired school employee’s pension should never be less than 75 percent of what it was worth at retirement.)

Under a defined contribution plan, once the payout begins, there is no way to add more money to the account. Therefore, because retired state and county employees have a DC plan, they are not entitled to a COLA. Thus, the yearly increases and the 75 percent of purchasing power guarantee are unavailable to them.

During retirement, the benefits of state and county employees remain the same because the DC plans do not provide a COLA. Thus, the value of their benefit declines over the years. School employees, by contrast, *do* have adequate benefits during retirement through both an automatic annual COLA and purchasing power protection.

The data showed that the DB plans that cover school employees, state judges, and state patrol had provided a 60 to 70 percent income replacement for those employees. However, the study also showed that the two DC plans for 18,500 state and county employees had provided an income replacement of only about 25 to 30 percent, despite the fact that both employees and employers contributed about 11.5 percent of pay each year. The DC plans’ low-income replacement ratio was the result of poor investment returns over many years.

As a consequence of these findings, Nebraska enacted a DB plan, using a cash balance model, for all state and county employees hired on or after January 1, 2003. Existing employees have the option to elect the DB plan.

The Status of DC Pre-Retirees

A related issue of concern is the amount of assets in a participant’s DC plan before he/she retires. According to year-end data from the Employee Benefit Research Institute (Source: EBRI *Issue Brief*, September 2003) as of the fall of 2002, the average 401(k) account (a type of DC plan available to many private-sector workers as their primary retirement benefit) was \$39,885.

\$ Value of 401(k) Accounts		
Year	average	median
1996	\$37,323	\$11,600
1997	\$41,156	\$11,873
1998	\$47,004	\$13,038
1999	\$55,502	\$15,246
2000	\$49,024	\$13,493
2001	\$43,215	\$12,810
2002	\$39,885	\$12,578

The EBRI data indicates that a few participants (upper quartile income) are doing well while the majority of 401(k) participants are not doing well at all. It also shows virtually no progress since 1996. In addition, none of the balances are even in the ballpark of what the participants will need to retire.

THREATS TO RETIREMENT INCOME SECURITY

In the last decade, the number of DC plans has increased while the number of DB plans has decreased. However, the trend is not as prevalent as some think. Most new DC plans are for small employers (less than 1,000 employees). There has been very little decline in DB plans with over 1,000 participants. Medium and large employers (100+ employees) use both DC and DB plans almost equally. Some 90 percent of state and local governments have DB plans. Until the mid-1990s, only two states had DC plans as the primary retirement vehicle for broad-based groups of employees. (Higher education faculty is a narrow exception to the previous rule – they sometimes have DC plan options.) West Virginia set up a mandatory DC plan for K-12 teachers hired on or after July 1, 1991. Teachers hired before then and other types of employees were in, and continue to be, in a DB plan. In the 1960s, Nebraska set up two DC plans, one for its general state employees and the other for its county employees. Judges, state troopers, and school employees have a DB plan.

During the past decade, various groups with a financial or political interest have worked to eliminate defined benefit plans that are provided to public employees and replace them with defined contribution plans, which are not guaranteed. While few public employers have abandoned their DB plans, economic conditions have increased pension funding pressures. DC proponents are seeking to exploit this situation by advocating and lobbying for conversion of DB plans to DC plans as a means to facilitate cost reduction.

What does a “conversion” of a DB plan into a DC plan mean? First, a conversion can mean that new employees must enter a DC plan whereas existing employees participate in a DB plan. Under this type of conversion, the DB plan is frozen. Second, a conversion can refer to a situation in which employees elect between a DB plan and a DC plan.

What is the consequence of a frozen DB plan or a DB/DC plan option? Instead of all the employer and employee contributions flowing into the DB plan, some of the funds are diverted into the DC plan. Thus, fewer dollars flow into the DB plan and the amount of money to pay pensions is less. One might think that the legislature that funds the plan has two options in such a situation: increase funding or cut benefits. Actually, the legislature has one option only – raising the funding level. The second option is rarely available in the public sector because strong contractual laws prohibit the reduction of

pension benefits. Thus, if a legislature approves a conversion in hopes of saving money, it may incur more cost than if it had retained the existing DB plan.

Why Is this Happening?

Many factors contribute to states' interest in converting their DB plans to DC plans. Some issues relate to a state's particular situation.

Some states feel they will save money through a conversion. Massachusetts Governor Mitt Romney proposed a DC plan for newly hired state workers in early 2003. His efforts were unsuccessful. In November 2003, the governor again took aim at public employee pensions. Ignoring the stock market decline, he stated that the overly generous benefits and early retirement incentives offered to teachers and state workers over the last several years helped create a "pension bond" that will seriously strain next year's budget.

Faced with a budget shortfall in 2003, Oregon considered a DC plan for newly hired workers. It settled on a DB/DC hybrid that consists of an employer-funded DB plan and an employee-funded DC plan.

In some cases, the pressure is external. DC plans and their individual accounts are more lucrative for vendors than are DB plans. Thus, potential vendors that provide investment options have a financial motive to push for conversion.

The Role of the American Legislative Exchange Council (ALEC)

In addition to the pressure from the vendors, a driving force in DC conversions is a group known as the American Legislative Exchange Council (ALEC). In 1997, ALEC released a paper called "Pension Liberation: A Proactive Solution for the Nation's Public Pension Systems." It criticized DB plans and argued that states should substitute DC plans for public employees.

Founded in the 1970s, ALEC bills itself as a group of 2,400 state legislators. In reality, ALEC is primarily an organization consisting of 270 representatives of trade associations, conservative foundations, and large corporations that provide its financial support. ALEC has nine task forces composed of legislators and private-sector representatives. The task forces draft model legislation that is introduced in the states at a rate of about 1,500 bills per year, according to *Governing* magazine (Source: Alan Greenblatt, "What Makes ALEC Smart?" October 2003).

The Portable Retirement Option (PRO) Act, discussed in "Pension Liberation," is one of ALEC's model bills. The PRO Act would authorize state and local governments to provide alternate DC plans to their employees. The plan would be administered by employers or

by service providers. The DB plan would be required to transfer the actuarial present value, as defined in the model legislation, to the DC plan administrator.

"Pension Liberation" presents inaccurate, incomplete, and misleading information:

DB vs. DC Coverage

ALEC asserts that over the past 20 years, the private sector has shifted dramatically toward defined contribution pension programs, while the public sector has retained defined-benefit plans. However, traditional defined benefit plans are far from disappearing in the private sector. ALEC fails to note that large private-sector employers, similar in size to many state and local governments, continue to embrace DB plans as the primary retirement vehicle for their employees.

Although the number of DB plans in the private sector has declined, 65 percent of the employers that terminated their plans covered between two and nine employees only (Source: EBRI, *Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega Defined Benefit Plans Remain Strong: Where We Are and Where We Are Going*, October 1997). One explanation for this activity is the complex federal regulations that apply to small, private-sector DB plans. These regulations are generally not applicable to public pension plans.

The number of large DB plans in the private-sector stayed relatively stable or grew from 1985 to 2002. The number of plans with 10,000 or more active participants grew from 500 to 796, or by approximately 60 percent. The number of workers in any size private-sector DB plan increased during the same period, from 38 to 44 million, according to the Pension Benefit Guaranty Corporation (PBGC), the insurer of private-sector DB plans (Source: PBGC, *2002 Annual Report*).

Large employers in the private-sector have retained their DB plans because they serve an important function in the employer's overall human resource strategy and, possibly, their business strategy. By and large, state and local government employers are much more comparable to large private sector employers in their outlook and needs than they are to the small private sector employers. State and local governments, which are also frequently large employers, should likewise be able to continue to benefit from the advantages of DB plans.

Portability

ALEC asserts that DC plans are fully portable and DB plans are not portable. ALEC fails to acknowledge that portability is no guarantee that retirement savings will be preserved for retirement.

Pension portability does not guarantee that when a plan participant changes jobs, he/she moves the retirement savings from the previous employer's retirement plan into another retirement vehicle. A terminating participant has three choices. First,

he/she can leave the funds with the former employer. Second, he/she can roll the funds over to another tax-qualified savings vehicle. For example, if the terminating participant goes to an employer with a retirement plan, he/she may have the option of rolling the funds from the previous employer's plan to the new plan. If the terminating participant's new employer has no plan (or if the individual does not go to work for another employer), he/she can roll the funds into an Individual Retirement Account (IRA). Third, the terminating participant can cash out, pay any applicable taxes, and spend the money.

EBRI examined U.S. Census data about what individuals did with retirement funds when they left a job (Source: EBRI, *Lump-Sum Distributions: An Update*, July 2002). In 1998, only 38.7 percent of individuals who reported ever having received a distribution (i.e., a withdrawal of retirement funds) from a previous employer's plan rolled a portion of the funds to tax-qualified savings, such as an IRA. Only 34.4 percent rolled over the entire amount. Thus, two-thirds of the individuals cashed out the distribution and used it for non-retirement purposes.

The EBRI data also shows that cash out rates tend to be lower for higher-balance plans and higher-income individuals. Conversely, those with smaller amounts of funds and who are classified as low income are those most likely to cash out. These are the individuals who are more likely to need additional financial support in retirement. In addition, younger employees are more likely to cash out retirement funds than older employees are, thereby eliminating the opportunity for such funds to increase in value.

The EBRI statistics demonstrate that a majority of individuals are choosing to use retirement savings for non-retirement purposes. This outflow of retirement funds may mean that individuals will have little, if any, retirement income during their retirement years.

Fairness

ALEC asserts that DB plans benefit long-term employees. Those who say that DB plans benefit only long-term employees do not understand how such plans operate. Short-term employees benefit because they will be eligible for a guaranteed retirement benefit funded with assets that are professionally invested.

Moreover, states have actively worked to help short-term employees preserve the value of their retirement benefit through:

- ▶ Allowing purchases of prior service credit;
- ▶ Reducing vesting periods;
- ▶ Indexing future retirement benefits of inactive retirement system members;
- ▶ Enhancing benefits of terminating members; and
- ▶ Creating hybrids that include both DB and DC plan features.

Benefits

ALEC asserts that employees want the freedom to invest their retirement savings to achieve higher returns and that DC plans have no limit on the benefits that workers can receive. ALEC ignores the reality that individual investors have difficulty beating the market.

Many people are adverse to risk in their investing and choose conservative investments. The 2000 study of the Nebraska Public Employee Retirement Systems revealed that between 1983 and 1999, the system's DB plans yielded an average of 11 percent per year, while the system's DC participants earned returns of 6 percent. Moreover, the study found that despite the system's efforts to educate employees about investments, more than 50 percent of the DC plan assets were invested in a conservative stable value fund.

Other data reinforces the difficulty an individual investor faces trying to achieve meaningful returns. The Wall Street Journal reported on a Boston consulting firm that measures an average investor's actual performance. From 1984 and 2000, the average stock-fund investor earned 5 percent, compared to 16 percent for the Standard & Poor's 500-stock index (Source: Ian McDonald, "Fundholder's Lament: All Bear, No Bull," *The Wall Street Journal*, April 25, 2002).

This disparity is explained by DB plans' long-time horizon. They can invest more aggressively than can individuals with DC plans and thereby earn higher long-term returns. DB plans are not limited by the retirement timing of a single individual. Thus, the investment horizon never has to be shortened and the risk need not be reduced. DC participants must assume increasingly conservative investment allocation as they near retirement. This action results in lower returns during both their working years and in retirement.

Moreover, even if a DC plan participant has had good success in his/her investments, external factors can erode their value. Market conditions at the date of retirement can significantly affect the level of a DC participant's retirement income availability. If the market is strong as in the 1990s, a participant will enter retirement with solid reserves of funds. A participant retiring during the recent market volatility will have a proportionately smaller amount of retirement funds. Because DB plans are long-term investors and the benefits they offer are guaranteed, the level of DB participants' benefits does not depend on outside economic forces.

As noted, most teachers, ESPs, and other public employees are covered by a DB plan that provides them with a guaranteed retirement benefit. Most also have available to them voluntary DC plans. These plans allow them to choose among different investment options. A DB plan and a voluntary DC plan address the objective of a guaranteed retirement benefit, while allowing individuals who desire

to manage their retirement funds the opportunity to save on a tax-deferred basis and invest in accounts as they direct.

Administrative Costs

ALEC incorrectly asserts that DC plans are less costly to administer than DB plans.

Retirement expenses have two components. The first is administrative expenses, which include record-keeping and investment management. The second expense is the cost of the benefit itself. This cost is represented by the contributions to fund the plan. In a DB plan, the employer pays the administrative cost, whereas employees pay most or all of it in DC plans.

Costs of DC plans are usually higher than DB plans, and, in most cases, much higher. For example, in 1999, the expenses for DB plans of the Nebraska Public Employee Retirement Systems were 0.30 percent of assets versus 1.50 percent for its two DC plans. The system administrator attributed the higher DC costs to higher investment management fees, record keeping expenses, and educational programs. Other research supports Nebraska's finding. A 1998 study of 401(k) fees and expenses by the U.S. Department of Labor (DOL) showed expenses ranging between 0.99 and 1.40 percent. (Source: "Study of 401(K) Plan Fees and Expenses," DOL, Pension and Welfare Benefits Administration, April 1998).

Administrative and investment expenses are a critical factor to the return received by a DC plan participant. According to the DOL study, a 1 percent increase in expenses could reduce the participant's account balance at retirement by 28 percent. The study's authors provided the following scenario as an illustration.

An employee with 35 years until retirement has a current 401(k) account balance of \$25,000. If returns on investments in the account over 35 years average 7 percent and expenses reduce the average returns by 0.5 percent, the account balance grows to \$227,000 at retirement, even if there are no further contributions to the account. If fees and expenses are 1.5 percent, however, the account balance grows only to \$163,000 or 28 percent less.

How do expenses of public DB plans compare? A review of 12 of the nation's largest plans revealed an average expense ratio of 0.25 percent, including costs for administration and investment management. The plans reviewed cover more than one-third of all active state and local government employees in the United States (Source: Keith Brainard, *Myths and Misperceptions of Defined Benefit Plans and Defined Contribution Plans*, National Association of State Retirement Administrators, May 2003).

DB plans have the ability to lessen their expenses through economies of scale related to their large size, negotiating beneficial investment management fees,

and, in some cases, by investing some assets using internal staff rather than external managers. Moreover, DB plans do not provide the costly individual services required of DC plans, such as updating participant accounts on a regular basis and distributing quarterly statements.

Accountability

ALEC asserts that DB funds are vulnerable to the possibility of mismanagement. This allegation unfairly characterizes the DB plans that serve teachers, ESPs and other public employees.

Trustees of pension plans – whether public or private – are subject to a strict set of laws known as fiduciary duties. These duties require them to act prudently by, for example, diversifying the investment of plan assets and to act loyally by carrying out their activities exclusively for the benefit of the plan participants. The Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC) define the duties for corporate retirement plan trustees. Trustees of public plans are subject to the IRC and similar standards found in state law as well as to state anti-conflicts of interest rules and codes of ethics.

Public retirement plans are also made accountable in other ways. They are subject to frequent audits by a state auditor, an independent auditor, or both; the results of which are distributed to key officers of a state's executive and legislative branches, and are available to the public. The systems also publish annual reports, providing the financial activities during each fiscal period, investment returns, and information necessary to allow valid comparisons of operating results among similar retirement systems. The reports may also include actuarial matters, such as a summary of plan provisions establishing benefits or otherwise affecting cost determinations, covered person data (for example, the number of active and retired members), plan assets, summary of assumptions used, valuation results, and contribution rates.

Moreover, all states have government-in-the-sunshine, freedom of information, and open meeting laws. Consequently, records and proceedings of the retirement systems are open except for information such as personal data about plan participants.

As a further protection, public retirement systems are generally separate from the respective employer or government that created them. Public retirement systems, for example, are frequently set up as independent agencies to insulate them from political pressure. As independent agencies, they have the power to set their own budgets, establish the actuarial assumptions that determine contributions, and hire staff. As additional evidence of their separation from the executive branches of their respective states, public retirement plans have on occasion sued the state to protect the interests of their plan participants.

For example, a court upheld a retirement board's claim against a governor that the state had been illegally delaying contributions to the retirement system, unconstitutionally impairing the members' contractual right to an actuarially sound retirement system (*Board of Administration v. Wilson*, [1997] 52 Cal.App.4th 1109, 61 Cal.Rptr.2d 207, the "Board of Administration" is the Board of the California Public Employees Retirement System).

In another case, the court affirmed the retirement board's power to hire its own attorney (*Hansen v. Utah State Retirement Board*, [1982] 652 P.2d 1332). In that case, the Attorney General filed suit seeking a judgment declaring that the Utah Constitution gave the Attorney General the exclusive authority to act as legal advisor to the state defendants. The Third District court granted defendants' motion for summary judgment. The Utah Supreme Court affirmed, holding that the defendant agencies were not executive department agencies and that the Attorney General did not have exclusive authority to act as their legal advisor.

DC Conversions

DB plans continue to provide a comprehensive package of guaranteed benefits to help ensure a high performance workforce in the public sector. A few DB/DC hybrids and DC options have been added, but they are integrated in various ways with the existing DB plan. The U.S. General Accounting Office (GAO) surveyed state retirement officials about actual efforts to convert DB plans to DC plans.

Among GAO's findings, conversions from DB to DC plans are rarely made.

Reasons cited were:

- Studies showed no need to change;
- Further study was needed;
- Opposition to the change; and/or
- Lack of interest or support.

In addition, GAO spoke to officials in states that never considered change. The most common reasons for not considering the change were:

- The DB plan provided greater benefits, including survivor and disability benefits;
- The DB plan was regarded as a better way to retain employees; and/or
- Little or no support existed for the change.

Source: GAO, "State Pension Plans: Similarities and Differences between Federal and State Designs," March 1999

Where public employees have had the chance to elect a DC plan, only a small number have done so. According to news accounts, the DC plan established by Florida has failed to attract the employees and assets initially expected. Only three percent of the 600,000 eligible workers have elected the plan, although 30 percent were estimated to do so. The low enrollment means that only \$200 million in assets, a fraction of the \$8 to \$13 billion expected, has moved into DC plan accounts. Michigan set up a DC plan in 1997. Only 6 percent of the eligible employees left the DB plan to enroll in the DC plan (Source: "Florida's 401(a) Effort has Underwhelming Beginning," Pensions & Investments, January 20, 2003).

Interesting developments are occurring in the two states that have longstanding DC plans. As noted above, Nebraska enacted a DB plan, using a cash-balance model, for all state and county employees hired on or after January 1, 2003. Existing employees have the option to elect the DB plan.

In West Virginia, the legislature approved a study about whether the mandatory DC plan for teachers hired on or after July 1, 1991, should be merged with the DB plan. The legislature justified the study as being "in the interest of providing a fair and stable retirement for our teachers consistent with principles of actuarial soundness of pension plans." The study was due on November 30, 2003. As of the date of publication, the report had not been released, although it is reported that the preliminary actuarial reports are very favorable. If the study results in a recommendation to merge and the legislature follows it, the DC plan will be effectively terminated in 2004 or thereafter.

CONCLUSION

In conclusion, a defined benefit pension plan is a superior retirement program for pre K-12 education employees. It is critically important to educate members about the value of their retirement benefits and urge them to act to protect these benefits. It is also important to make sure that legislators and the public know the truth about defined contribution plans and their proponents.

The NEA Pre K - 12 Retirement Security Toolkit contains a variety of resources to assist state and local associations in protecting the retirement benefits of their members. This information can help state and local associations plan their strategy, build their case, activate members, reach out to the public, and educate elected officials.