PERSI

May 26, 2011

With retirement systems nationwide continuing to receive media attention, now seemed like a good time to share with you some of the research compiled by my staff regarding retirement. While the information in this initial report may be familiar to you, for others it will be new. Over the coming weeks you will receive several communiqués from me that will go into greater detail about the research findings, including a presentation by Senator Liljenquist of Utah, and will cover PERSI's funding status and sustainability outlook, explain the differences between PERSI and other state systems, and will also include a comparison to and analysis of the Utah model.

During the 2011 legislative session, I remarked that time was on our side. That is still true today. While due diligence takes time, it is necessary to accurately determine what changes, if any, are necessary for public pension plans. States that made hasty changes in the past are now trying to reverse those decisions; no one wants that to happen in Idaho. By sharing relevant data, I hope to assist lawmakers in their assessment of Idaho's needs. Below is a summary of the enclosed report.

Pension System Perspectives in Today's Environment

- Defined Benefit Plans
    - Guaranteed benefit; funded by contributions & investment revenues
    - Risk shared by employer and employee
- Defined Contribution Plans
    - No guaranteed benefit; benefits stop when account is depleted, regardless of retiree's age or circumstance; may force employees to work beyond retirement age
    - Success in a DC plan relies on investment choices & financial decisions (ave. return 2.5%)
        - Participants may withdraw funds (leakage); can leave them unprepared at retirement
- Hybrid Plans
    - Some plans combine DB and DC features
    - Annuity or lump sum payments at employment termination among the options
- Employee Compensation Truths
    - Differing opinions on how public sector wages compare to private sector wages
    - Retirement benefits are key to attracting & retaining quality employees
    - Reduced retirement benefits increases need for higher wages
- Risks of Inadequate Retirement Resources
    - Without adequate savings, retirees may rely on taxpayer funded public assistance programs
    - DB doesn't guarantee successful retirement; does help control states' social risk
- PERSI
    - Legislators created sound infrastructure with built-in safeguards to prevent abuse of benefits
    - PERSI is currently valued at $12.2 billion; nearly a 65% gain since 2009
    - PERSI funded ratio is 91.7%; PEW Center study says 80% equals solid performer
    - $463 million in retirement benefits paid in Idaho; generates $28 million in tax revenue

Best regards,
Don Drum
Executive Director

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Pension System Perspectives in Today's Environment

The Great Recession created far reaching economic impacts, including state retirement systems stressed by market losses and aggressive return assumptions. Many state leaders are questioning whether the systems are cost effective and \ or sustainable. Balancing risk, taxpayer cost, and retirement plan sustainability are issues states across the nation are struggling with to retain the viability of their retirement systems. This report presents summaries of Defined Benefit (DB), Defined Contribution (DC), and Hybrid Defined Benefit retirement plans to help clarify the myriad issues.

A traditional Defined Benefit plan offers a guaranteed benefit throughout a participant's retirement years. Historically, employers made contributions to DB plans; as the plan sponsor and sole contributor, those employers assumed all the risk for sustainability of the plan. The market decline and associated losses by state plans have resulted in taxpayers questioning the sustainability of these plans and the associated cost \ risks of traditional DB plans operated by the public sector. An alternative to the traditional DB plan surfaced in the private sector decades ago, when employers began methodically moving towards Defined Contribution (DC) plans.

Defined Contribution (DC) plans are the norm in the private sector, when and if they are offered to employees. Even so, DC plans are being questioned based on recent findings indicating those plans are not providing the funding necessary for their participants' retirement security. A DC plan can be described as a retirement savings program where an employee contributes up to a maximum percentage of their gross income as set by their employer, while the employer may contribute a portion of that amount to their employees' account during employment, but with no guaranteed retirement benefit. The ultimate benefit is based exclusively on contributions to and investment earnings of the plan. The benefit ceases when the account balance is depleted, regardless of the retiree's age or circumstances.

According to JP Morgan's quarterly capital market presentation, over the past 20 years the average return for DC plan participants is only 2.5 percent. Recently, DC plan sponsors expressed growing concerns about leakage, which is the early withdrawal of money by participants from their retirement accounts for uses other than retirement. While DC plans allow participants some flexibility not available in a DB plan, a DC plan's success depends on the investment choices and financial decisions made by each participant. Generally employees make decisions counter to their best interests, such as engaging in market timing practices, taking too much or too little risk, neglecting or over-managing their account, or not following diversified investing practices (e.g., allocating their assets among different asset classes). The result of these employee choices is often insufficient retirement savings, forcing employees to work much beyond their ordinary retirement age.

Due to concerns voiced by some state leaders around the country, the retirement industry seems to be evolving. Many systems operating as DB plans are considering changes, which will adjust their plans to become DB Hybrids. Hybrid plans, such as cash balance plans and pension equity plans (PEP), are special types of defined benefit pension plans that combine features of both DB and DC plans. Today's most common hybrid plan designs are defined benefit plans that express benefits as the value of a hypothetical account balance. Participants receive statements that display the accumulation of contributions and interest credited to their hypothetical accounts. While hybrid plans provide for an annuity as the normal form of payment, a lump sum payment option is almost always available at termination of employment.

Public Employees Compensation Package

Historically, public employers are paid wages lower than similar positions in the private sector. The FY2012 CEC Report to the Governor stated, "The gap between State employees' salaries and market salaries obviously cannot be made up in one year. It will require a long-term commitment to addressing State employees' salaries to close the gap." Public employers have been able to attract and retain staff due to the quality of their "total compensation package". The total compensation package includes wages, leave, health, and retirement benefits. Many public employers contend offering and maintaining a reliable retirement plan is essential to attracting and retaining qualified staff. Employers are concerned if changes are made to their employee retirement plans, which may result in lower retirement benefits, employers will need to significantly adjust wages upward to attract and retain quality staff.

As an additional concern, if retirement systems are not able to provide employees with retirement security, studies show employees will work longer to accumulate adequate retirement savings. The risk to public employers with an aging work force is higher health insurance costs. All components of the total compensation package must be considered as changes to the retirement plans of public employers are explored.

States' risks if individuals cannot retire and/or have inadequate retirement savings

If a retiree (public or private sector) fails to accumulate the necessary savings to provide an adequate income at retirement, the welfare system of the state could possibly be called upon to provide support. States bear a social cost risk when individual citizens cannot support themselves in retirement. The guaranteed benefits of state-sponsored DB plans do not ensure a successful retirement for public employees; however, it can be argued they do help control the states' risk. Controlling risk is important when considering every state in America today except for two—Indiana and Wisconsin—has more government workers on the payroll than people manufacturing industrial goods.

A *Wall Street Journal* article titled, "Retiring Boomers Find 401 (k) Plans Fall Short," stated, "The median house headed by a person aged 60 to 62 with a 401(k) account has less than one-quarter of what is needed in that account to maintain its standard of living in retirement." If these individuals elect to work longer, employer health insurance costs will most likely increase; if they retire and fail to sustain themselves, the state could incur greater social costs.

Does Idaho need to change?

The Idaho Freedom Foundation's Executive Director Wayne Hoffman recently stated he plans to propose changes to Idaho's public employee retirement system, quoting "It is a bad system and it should go away." Past Idaho legislatures effectively partnered with the PERSI Board to create an infrastructure that has protected the fund, fund participants and ultimately taxpayers. PERSI is recognized nationally as a retirement system which has established and adhered to the necessary funding and cost control principles for success. As of April 29, 2011, the PERSI fund had a funded ratio of 91.7 percent and a fund value of approximately $12.198 billion. The PEW Center on the States says retirement systems funded at 80 percent or higher are solid performers. PERSI pays more than $463 million in retirement benefits to Idaho residents annually; the National Institute of Retirement Security (NIRS) estimates those benefits generate approximately $28 million in taxes revenue for the state.

Many states are making adjustments to the economic assumptions associated with their retirement systems. Once again, the foresight of our past legislatures stands out as these systems are adjusting to where Idaho has consistently been. Since its inception in 1965, PERSI has always required plan participants to share the cost and the risk. Some states, including our neighbor Utah, did not require employees to share in the cost or risk of their retirement plan; as a result, it was recently determined significant changes were needed. Idaho, unlike many other states, has always chosen to err on the side of conservative assumptions by providing modest but funded benefits to our employees in their retirement years.

In summary, PERSI is a good system. This assertion is backed up by reports from independent organizations that study pension system performance. The PERSI Board and past legislatures have always been vigilant and proactive when considering changes to PERSI. Idaho, like all states, must constantly evaluate its economic assumptions, benefits, and costs. While there are risks associated with sustaining the PERSI system, there are also risks associated with changing it. The PERSI Board and the Idaho Legislature have established a good long-term working relationship. Together, they have effectively controlled risks and positioned Idaho as a national leader in "the right way" to structure, fund, and manage public employee retirement.

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