ORSC

**The Ohio Retirement Study Commission**
88 East Broad Street, Suite 1175
Columbus, OH 43215
(614) 228-1346 Phone
(614) 228-0118 Fax



# *Analysis*

## H.B. 199 - Rep. Cates, et al.
## (As Introduced)

**Glenn Kacic - Contact Person**
**(614) 228-1346**

Establishes an alternative retirement program for Ohio's public employees electing such program in lieu of membership in the Public Employees Retirement System (PERS), the Police and Firemen's Disability and Pension Fund (PFDPF), the State Teachers Retirement System (SIRS), the School Employees Retirement System (SERS), and the Highway Patrol Retirement System (HPRS). [1]

The bill is modeled after the provisions enacted in H.B. 586 (eff. 3/3l/97), which currently permit academic and administrative employees of public institutions of higher education to choose an alternative defined contribution plan in lieu of membership in PERS, STRS or SERS. The bill would extend this same choice to all other public employees currently covered under one of the five state retirement systems.

## Establishment of Alternative Retirement Plan for Ohio's Public Employees

The bill would establish an alternative retirement program for Ohio's public employees who are not receiving benefits from a state retirement system and who are otherwise required under current law to contribute to one of the five state retirement systems.

The bill would permit these employees to elect to opt out of the state retirement systems and participate in an alternative retirement program. New hires would be requited to make the election within 90 days of employment. If no election is made, the new hire would be deemed to have elected participation in the state retirement system covering such employment.

Current employees with less than five years of service credit would be required to make the election within 120 days after the employer establishes an alternative retirement program. If no election is made, such employees would remain members of the state retirement systems.

All elections shall be in writing and submitted to a designated officer of the employing unit. The officer shall file, within 10 days, a certified copy of the election with the state retirement system that would otherwise provide coverage. Once made, all elections would be irrevocable while the employee is continuously employed.[2]

Under the bill, the alternative retirement program would consist of three or more defined contribution plans providing retirement and death benefits through the purchase of fixed or variable annuity contracts selected by the employee.

Generally, in a defined contribution plan, the employer only promises to allocate a specified contribution, generally some percentage of the employee's annual salary, to the employee's individual account. The employer does not promise the employee any specific benefit amount at retirement; rather, the employee receives a benefit in an amount determined by his or her account balance, the interest rate expected to be earned on funds in the account and the anticipated length of time the benefit is to be paid. Under this type of plan, the employer's liability is limited to each

[1]The election provided under the bill would be limited to new hires and current members with less than five years of total service credit.

[2]An employee is continuously employed if no more than one year intervenes between each period of employment.

year's required contribution; the employee bears all investment risk.

In contrast, the state retirement systems are generally defined benefit plans providing comprehensive retirement, disability, survivor, death, cost-of-living and health care benefits to members and their beneficiaries. These benefits are partly in lieu of Social Security which does not provide coverage for public employment covered under the state retirement systems. In a defined benefit plan, the employer agrees to provide the employee a benefit amount at a stipulated retirement age, based on a specified formula. The formula is typically based on years of service and earnings. Under this type of plan, the employer is responsible for ensuring that the contributions made by the member and the employer are sufficient, when combined with earnings on pension assets, to fulfill benefit promises. The investment risk is borne by the employer.

Currently, members of the state retirement systems may participate on a voluntary basis in certain defined contribution plans to supplement their retirement income from the systems. Members of all live systems may choose to contribute on a pre-tax basis to an Internal Revenue Code (IRC) §457 state and local government deferred compensation plan, such as the Ohio Public Employees Deferred Compensation Program. Members employed in various educational positions may also choose to contribute on a pre-tax basis to an IRC §403(b) tax-sheltered annuity plan, such as VALIC.

The bill would require the Department of Insurance to designate three or more entities to offer defined contribution plans to participating employees. Each entity offering a plan would be required to meet the following two conditions: (1) it must be authorized to sell annuity contracts or certificates in Ohio; and (2) it must provide the plan in at least 10 other states.

In designating any entity, the Department of Insurance would be required to consider all of the following factors: (1) the experience of the entity; (2) the potential effectiveness of the plan in recruiting and retaining employees; (3) the nature and extent of the benefits offered under the plan; (4) the relationship between plan contributions and plan benefits; (5) the suitability of the rights and benefits offered under the plan to the needs and interests of employees; (6) the capability of the entity to provide the benefits under the plan; and (7) any other relevant matters. The Department would also be required to periodically review each designated entity, and rescind any designation if the Department finds that the entity is not in compliance with the requirements and conditions enumerated above. Designations made by the Department would nor be subject to the competitive bidding requirements under Ohio law.

Under the bill, the employer would be required to enter into contracts with at least three designated entities offering a plan.[3] If there are fewer than three entities offering a plan to a particular group of public employees, the employer would be required to enter into a contract with those entities offering a plan to its employees. The employer would also be required to permit participating employees to change plans if an entity's designation is rescinded. Employers would be authorized to perform the necessary functions for administering each plan.

Participating employees would be required to contribute the same percent of salary to the alternative retirement program as they would have otherwise been required to contribute under the applicable

[3]Under current law, the board of trustees of each public institution of higher education is required to contract with each entity designated by the Superintendent of Insurance that offers a defined contribution plan.

state retirement system.[4] In no case shall the percentage be less than three percent. Employee contributions may be made on a pre-tax basis under an employer "pick-up" arrangement as authorized under IRC §414. A participating employee may also elect to make voluntary contributions to the plan in addition to those required.

Employers would be required to contribute a percentage amount of the electing employee's salary as determined by the employer. In no event shall the aggregate amount contributed by the employee and the employer be less than the amount necessary to qualify as a bona fide state and local retirement plan under IRC regulations.[5] In addition, the employer would be required to contribute six percent of the employee's salary to the applicable state retirement system to mitigate any negative financial impact on the system's funding resulting from the establishment of an alternative retirement plan. On July 1, 1999 and every year thereafter, the Ohio Retirement Study Council (ORSC) would be required to complete an actuarial study to determine if any adjustment to the six percent rate should be made, and submit it to the Director of Administrative Services and the chairs of the standing committees and subcommittees with primary responsibility for retirement legislation.[6] Any increase or decrease in the six percent rate would become effective on the first day of July in the year in which the actuarial study is completed. This supplemental contribution made by employers on the salaries of their electing employees would continue until the unfunded actuarial accrued pension liabilities of the system are fully amortized, as determined by the system's annual actuarial valuation.

The bill would prohibit the state or employer from (1) being a party to any annuity contract purchased by a participating employee under any alternative retirement plan; and (2) paying any retirement, death or other benefits under an alternative retirement plan. Benefits under an alternative retirement plan would be payable to participating employees or their beneficiaries only in accordance with the contract entered into by the employee.

The bill generally would provide that benefits under an alternative retirement plan are neither assignable nor subject to attachment, garnishment, the operation of bankruptcy or insolvency laws, or other legal process, with the following two exceptions: (1) court-issued withholding orders for restitution under Ohio's theft in public office law and for certain sex offenses; and (2) court-issued withholding orders for alimony and child support.[7] The bill would also exempt benefits under an alternative retirement plan from any state, county, municipal or other local tax, except for the state

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[4]The current employee contribution rates are as follows: PERS - 8.5%; PERS-LE - 9.0%; PFDPF - 10.0%; STRS - 9.3%; SERS - 9.0%; and HPRS - 9.5%.

[5]The required contribution late is 7.5% for defined contribution plans. The contribution may be entirely made by either the employee or employer, or some combination of the two.

[6]Current law provides that the ORSC shall complete the actuarial study on July 1, 1999 and every third year thereafter.

[7]Under current law, benefits under an alternative retirement plan established by a public institution of higher education are not subject to court-issued withholding orders for restitution to the victim relative to certain sex offenses committed in the context of the offender's public employment.

income tax and school district income tax. Currently, benefits under the state retirement systems are subject to the same legal provisions.

Except as provided below, upon the application of a member who elects an alternative retirement plan, the bill would require the state retirement systems to transfer the member's accumulated contributions, without interest, to the entity providing the alternative retirement plan, thereby canceling all service credit and benefit rights in the state retirement systems. The bill would provide in accordance with existing STRS law for the payment of interest and, if the member has at least five years of service credit, a portion of the employer contributions on this transfer.

The bill would prohibit members from purchasing service credit under the state retirement systems for any period of employment covered under an alternative retirement plan.

**Background** - Defined benefit plans remain the predominant primary retirement plans among public employers, covering 90% of full-time state and local government employees.

Ohio is no exception. Ohio sponsors five statewide public employee retirement systems, which arc defined benefit plans. Ohio's public employees are not covered by Social Security.

There is, however, a growing interest in defined contribution plans among public employers. Approximately 10% of full-time state and local government employees participate in defined contribution plans. Generally, defined contribution plans in the public sector are supplemental rather than primary retirement plans, with the notable exception of teachers in colleges and universities who are typically covered under a defined contribution plan, such as TIAA-CREF. There are only three states where the primary statewide retirement system is a defined contribution plan: the Nebraska State and County Employees' Retirement Systems; the West Virginia Teachers' Defined Contribution Retirement Plan created in 1991; and the Michigan State Employees Retirement System Defined Contribution Plan created in 1996.

There are, however, various states that have established alternative defined contribution plans for specified public employees, including statewide elected officials, legislators and most gubernatorial and legislative staff in Colorado (1998); non-classified state employees in Vermont (1998); and state political appointees of the executive branch in Virginia (1998). Other states have created "hybrid" plans by incorporating certain defined contribution features into their traditional defined benefit plans, including an optional employer-funded defined benefit plan and an employee-funded defined contribution plan for teachers and non-certificated school employees in Washington (1997, 1998), and cash balance accounts consisting of employee contributions, credited with a stated rate of interest each year, plus all or some portion of the employer contribution for employees terminating employment prior to retirement in California (1996), Colorado (1995), Iowa (1999) and South Dakota (1995). Still other states have implemented an employer match for state employees participating in a supplemental 401(k) or 457 defined contribution plan, including Missouri (1996), Maryland (1998) and Oklahoma (1998). Legislative studies of alternative defined contribution plans are currently pending in Arizona, Florida, and Kansas.

Defined contribution plans are not new in Ohio. Originally, each of the three non-uniformed employee retirement systems - PERS, STRS, SERS - provided an allowance based on a "money purchase plan." Basically, such plan provided that the retired employee receive a monthly annuity in an amount that the aggregate contributions of the employee and the employer, with interest, would buy at the time of retirement based upon the life expectancy of the individual. There was no guaranteed benefit amount.

During the 1950's, the Ohio General Assembly established a defined benefit plan in each of these systems, but retained the defined contribution feature of the "money purchase plan." Each system provided the retired employee the greater of a defined benefit based on a percentage of the employee's final average earnings multiplied by years of service or a money purchase benefit based on the sum of the employee's contributions and the employer's matching contribution, both of which are credited with interest. The vast majority of employees now retire under the defined benefit plan; greater benefits are generally provided under the money purchase plan for those employees who separate from public service several years prior to retirement.

Two other types of defined contribution plans are offered on a supplemental, voluntary basis to Ohio's public employees. Members of all five retirement systems may defer income on a pre-tax basis under a section 457 state and local government deferred compensation plan. Public educational employees may also defer income under a section 403(b) tax-sheltered annuity plan.

- ***General Description of DB and DC Plans*** - A defined benefit plan defines the amount of each employee's benefit. This promised benefit is usually based on the employee's earnings, length of service or both, and is independent of investment performance. For example, the Public Employees Retirement System provides for an annual benefit equal to 2.1% of the member's final average salary multiplied by the first 30 years of service, plus 2.5% of final average salary multiplied by each year of service in excess of 30, up to a maximum of 100% of the member's final average salary.

In a defined benefit plan, there are generally no individual accounts; all assets set aside to fund the benefits for all members are usually combined to provide the benefits payable under the plan. The employer contributes to the plan such amounts which are estimated to be sufficient to pay the plan benefits. These estimates are based on assumptions on future rates of interest, salary increases, mortality, withdrawals from the plan and other factors. If the plan experience differs from these estimates, for example, earning more or less investment return than assumed, this will increase or decrease the amount of employer contributions needed in future years.

In contrast, a defined contribution plan defines the amount of the employer contribution for each employee. The contribution is usually determined as a percentage of each employee's earnings, such as 10% of pay. The benefit payable at retirement is based on the money accumulated in the employee's individual account. Such accumulated money includes employer contributions, employee contributions (if any) and investment gains or losses. It may also include account balances forfeited by employees who leave before they become vested to the extent such forfeitures are reallocated to the accounts of employees who remain. The benefit is generally paid as a lump sum, a series of installments over a period of years or a monthly annuity for life. The amount of benefit is largely dependent on the investment performance of each employee's individual account.

In short, a defined contribution plan defines the amount of contribution paid into the plan, whereas a defined benefit plan defines the amount of benefit paid out of the plan. Under a defined contribution plan, the amount of contributions is known, but the amount of future benefits is uncertain. Under a defined benefit plan, the amount of benefit is known, at least as a percentage of earnings per year of service, but the amount of contributions that will be needed to fund future benefits is less certain.

- ***Major Differences Between DB and DC Plans*** **-** Both defined benefit plans and defined contributions plans have their relative merits and drawbacks in terms of their use. The following key factors are identified to provide further understanding of the differences between the two types of plans.

- ***Retirement Income*** **-** In a defined benefit plan, retirement income is based on a benefit formula that is typically tied to an employee's earnings and years of service, and does not rely on investment performance. This not only provides employers with the ability to design plans that attempt to satisfy stated retirement income objectives, but also provides employees with a predictable retirement benefit.

In contrast, defined contribution plans provide retirement income based on the investment performance of the employee's individual account and the level of contributions. Simply put, the greater the real rate of return, the greater the benefit to the employee; the lower the return, the lower the benefit amount. Accordingly, there is no way of knowing in advance the amount of assets that will be in the employee's account at retirement as defined contribution plans are not specifically designed to provide stated retirement benefit levels. Though employers may structure contribution schedules to meet target levels of retirement income, the actual benefits payable at retirement can be far below or far above the target, depending on the investment experience.

- ***Plan Costs*** **-** In a defined benefit plan, the employer bears the rewards and risks of favorable or unfavorable experience under the plan, and thereby accepts an uncertain cost commitment. Numerous factors affect the cost of benefits under a defined benefit plan, including the rates of return on investments, future salary increases, mortality, separation from employment, and other economic and non-economic conditions. This uncertain cost is minimized by the use of actuarial projections relative to all of these factors with the objective of establishing a reasonably level funding pattern. The ultimate cost of the plan, however, is fixed by statute. Under a defined benefit plan, favorable or unfavorable experience with respect to investments, salary levels, mortality and other factors will decrease or increase the employer's cost, but will not affect the amount of promised benefits payable to employees.

In contrast, the employer cost under a defined contribution plan is known each year as the employer is only committed to allocate a specified contribution amount to each employee's individual account. The employer does not promise the employee a specified benefit amount at retirement. Under a defined contribution plan, there are thus no unfunded liabilities.

- ***Investment and Inflation Risk*** **-** In a defined benefit plan, employers assume an obligation to pay a specified future benefit, and accept the investment risk in meeting such obligation. Unfavorable investment experience might require the employer to make additional contributions to the plan. Favorable investment experience might result in either a reduction in the contribution amount from employers or an increase in benefits for employees, or some combination thereof.

In a defined contribution plan, however, the employee bears the investment risk. Favorable investment results will increase benefits; unfavorable investment results will decrease benefits.

Defined benefit plans may also provide better protection against inflation during employment, especially those plans which provide a benefit based on a percentage of the employee's final pay. However, employees who cease employment prior to retirement generally receive no inflation protection under a defined benefit plan. Upon retirement, most state and local government employees covered under defined benefit plans receive an annual cost-of-living allowance; other plans often provide for ad hoc post-retirement increases.

Defined contribution plans may also provide protection against inflation during employment through investment returns, although at a higher risk to the employee. A conservative investor who selects a fixed-income portfolio may not receive sufficient protection against inflation. Upon retirement, defined contribution plans do not typically provide for an annual cost-of-living allowance, though some plans all employees to convert their account balances to either a level annuity or one that increases by a fixed percentage each year. The initial benefit under the increasing annuity is obviously lower than the amount under the level annuity.

- ***Recruitment and Retention of Employees*** **-** Defined benefit plans tend to favor older, long-tenured employees and employees making permanent job changes relatively late in their careers. Since the benefit is typically tied to the employee's earnings and length of service, benefits in a defined benefit plan accrue at a slower rate during the initial years of service and accrue at a faster rate for employees near retirement. Mobile employees generally suffer large benefit losses under a defined benefit plan because each time a change in employment occurs, a fixed benefit is determined . . . a benefit that no longer increases with salary increases and years of service.

In contrast, defined contribution plans tend to favor younger, more mobile employees. Employees who change jobs several times do not typically incur large benefit losses because defined contribution plans often provide for vesting with less service, which enables more employees to take advantage of the accumulated benefits than under a defined benefit plan. Assuming they do not spend the defined contribution benefit after leaving the job, investment income may continue to accrue in a tax-deferred vehicle until retirement.

In short, the defined benefit plan is designed in part to retain workers for full careers, whereas the defined contribution plan is more likely to attract younger, more mobile employees.

- ***Portability*** **-** Defined contribution plans typically provide greater portability of benefits than defined benefit plans, primarily due to shorter vesting requirements. This allows employees who move from job to job to continue accumulating benefits throughout their entire working career.

In contrast, most employees in defined benefit plans do not work a full career with the same employer, or even with a related group of employers. This often results in short-tenured employees earning different or sometimes no retirement benefits in each position. Vested benefits accrued for earlier service are generally not as large as vested benefits accrued for the same length of later service because such earlier benefits are usually based on the salary at the time employment terminates rather than upon the employee's final average salary at retirement.

Many states have recognized this problem for short-tenured employees by reducing vesting requirements and/or providing for complete portability among various units of state and local government. Nevertheless, there is still a significant portability issue between public and private employment as well as between the various states.

- ***Recent Legislative Activity***

As part of the findings and recommendations included in the final report of the Joint Legislative Committee to Study Ohio's Public Retirement Plans (December 11, 1996), the ORSC staff made the following observation:

"Portability has become a national retirement issue. It has also become an issue in Ohio in terms of the recruitment of higher education employees and is likely to become an increasing issue for other groups of public employees, such as part-time, short-service and mobile employees, who are required to participate in the retirement systems which are designed to benefit older, long-tenured employees and employees making permanent job changes relatively late in their careers."

It also made the following recommendation:

"That an alternative retirement plan be established, in conjunction with the existing defined benefit plan, in the three non-uniformed employee retirement systems to provide greater portability and options for employees."

In response, the Ohio General Assembly enacted H.B. 586 (eff. 3/31/97) which established an alternative defined contribution plan for academic and administrative employees of public institutions of higher education electing such plan in lieu of participation in PERS, SIRS or SERS. Pursuant to this legislation, the Ohio Department of Insurance designated the following entities as providers: Aetna Life Insurance and Annuity Company; Equitable Life Assurance Company; Greater American Life Insurance Company; Lincoln National Life Insurance Company; Metropolitan Life Insurance Company; Nationwide Life Insurance Company; Teachers Insurance and Annuity Association; and Variable Annuity Life Insurance Company. Ohio University and the University of Cincinnati were the first to establish such plans for their eligible employees, with other public institutions of higher education currently in the process of doing so. According to STRS, roughly 60% of eligible employees elected to transfer from the STRS defined benefit plan to the newly-established defined contribution plans.

H.B. 586 also established an alternative benefit payout plan for STRS members upon the withdrawal of the member's accumulated contributions due to termination of employment or death. Under the alternative benefit payout plan, STRS members may elect a lump-sum distribution consisting of the member's accumulated contributions, credited with a stated rate of interest compounded annually, plus a 50% employer match for members with at least five years of service. Annual compound interest shall not exceed four percent for members with less than three years of service and six percent for members with more than three years of service.

The Ohio General Assembly also enacted S.B. 82 (eff. 3/6/97) which, among other things, required PERS, STRS and SERS to propose an alternative benefit program for their members. The PERS proposal was modeled after the STRS alternative benefit payout plan established in H.B. 586, and would provide for a lump-sum distribution consisting of the member's accumulated contributions, credited with annual compound interest at rate no greater than four percent, plus a 33% employer match for members with at least five years of service and a 67% employer match for members with at least 10 years of service.

The SERS proposal consists of three alternatives; the first alternative would index the member's accrued benefit at termination of employment to changes in the consumer price index, payable at age 60; the second alternative would also index the member's accrued benefit at termination of employment to the lesser of three percent or the change in the consumer price index, payable at age 60; and the third alternative would simply increase the interest rate credited to the member's accumulated contributions at retirement under the existing money purchase plan. Unlike the PERS and STRS alternative benefit payout plans, none of the SERS alternatives addresses the issue of portability of benefits upon termination of employment prior to retirement. Under all three alternatives, the member must reach retirement age before receiving any additional benefits which would remain subject to the Social Security offsets. Members would continue to receive only their accumulated contributions, without any interest or employer match, upon the withdrawal of contributions prior to retirement.

In response to this particular bill, STRS is considering having separate legislation introduced to incorporate a defined contribution plan into its existing benefit structure. Also, PERS has an alternative benefit payout plan under consideration.

These above legislative enactments clearly indicate an intent to accommodate the recruitment needs of employers and to provide members of the non-uniform employee retirement systems more flexibility, portability and choice in planning for their individual retirement needs.

At the federal level, legislation has also been introduced to promote the portability of retirement benefits. Such legislation would remove existing barriers between various deferred compensation, defined contribution and defined benefit plans so that employees may have a better opportunity to manage and preserve their retirement benefits when they switch jobs. The primary provisions that would apply to governmental pension plans include the following: allowing rollovers of retirement benefits between and among 457, 403(b) and 401(k) plans, and certain types of IRAs when employees change jobs; allowing rollovers/transfers from all deferred compensation/defined contribution plans to public employee defined benefit plans in order to purchase permissive service credit; allowing refunds/distributions from public employee defined benefit plans to be rolled into deferred compensation/defined contribution plans; and permitting increased flexibility with respect to the size and frequency of benefit payouts of 457 plans. All of these provisions would help employees manage and preserve their retirement benefits, especially those who have worked among various public, non-profit and private institutions.

**Staff Comments -** H.B. 199 raises a number of important public policy issues regarding the pension coverage of Ohio's public employees and the operations of the state retirement systems. The public policy issues require careful consideration before any decisions are made.

What follows is a brief capsule of the various public policy issues raised by the bill.

· ***Ancillary Benefits* -** Ohio's state retirement systems provide for disability, survivor and retiree health care benefits. No provision is made for these ancillary benefits under the alternative defined contribution plans established under the bill.

This is a particularly important issue in Ohio due to the absence of Social Security coverage for Ohio's public employees. Equally important is the concern that employees who initially opt out of the state retirement systems may subsequently opt back into the state retirement systems to obtain these ancillary benefits by leaving public employment for more than one year before returning. Such adverse selection would create additional costs to the state retirement systems.

As in other jurisdictions, these ancillary benefits could be provided through insurance policies or through the existing disability, survivor and health care programs of the state retirement systems. To the extent these benefits are provided, the cost will either create an additional payroll cost or reduce the amount paid into the alternative defined contribution plan.

- ***Contribution Rates*** **-** Employee and employer contribution rates are established either by statute or by the retirement boards of the state retirement systems within certain statutory limits, and apply uniformly to members of a particular class of public employees throughout the state, such as teachers, firefighters, police officers, etc. Under the bill, employees electing a defined contribution plan would be required to contribute the same amount as required under the state retirement system otherwise providing coverage. However, the bill would authorize each employer to determine the employer contribution amount to the defined contribution plan.

As a consequence, employer contributions to a defined contribution plan could vary throughout the state, and could become the subject of collective bargaining. Moreover, two employees who are required to contribute the same amount could receive different benefit amounts based solely on the individual employer that employs them. At issue is whether the statewide nature of the current defined benefit plans should also apply to the proposed defined contribution plans under the bill.

- ***Fiscal Impact*** **-** The bill is intended to have no negative fiscal impact upon the state retirement systems. Under the bill, each employer of an electing employee would be required to make a supplemental contribution of six percent of the electing employee's salary to the state retirement system otherwise providing coverage. The ORSC actuary would be required to complete an actuarial study each year to determine any necessary adjustments to the six percent. This supplemental contribution would continue until the unfunded pension liabilities of the system were fully amortized, as determined by the system's annual actuarial valuation.

The initial supplemental contribution of six percent is simply a carryover from H.B. 586, which was based on actuarial analyses prepared by the STRS actuary and the ORSC actuary relative to the establishment of an alternative defined contribution plan for higher education employees. The ORSC actuary based its analysis on the actual experience of Montana's alternative retirement plan for higher education employees as applied to STRS. Given the expansion of the bill to include all public employees of the five state retirement systems as well as the different demographics of their memberships, there is no actuarial basis to assume the reasonableness of this six percent rate for any of the five retirement systems without further study.

This initial rate is critical, even though the bill provides for future adjustments thereto. Apart from their interest in recruiting qualified employees, employers are also interested in controlling retirement costs. The amount they establish to contribute to the alternative defined contribution plan is largely contingent on the supplemental amount they will be required to contribute to the state retirement systems. To the extent that this initial supplemental contribution rate is set too low and requires a significant increase in the following year, employers will be forced to either reduce their contributions to the alternative defined contribution plan or incur higher retirement costs. Employees who make an irrevocable election to participate in the defined contribution plan are likely to find this first option unacceptable.

Also, the bill provides that the supplemental contribution would continue until the unfunded pension liabilities of the retirement system were fully amortized, as determined by the system's annual actuarial valuation. Under the bill, there is no specific method for determining whether changes in the unfunded pension liabilities of the system are a result of the establishment of the alternative defined contribution plan or a result of subsequent benefit improvements or other actuarial experience unrelated to the establishment of the alternative defined contribution plan. Moreover, the actuarial assumptions and methodologies used in the systems' actuarial valuations would have a direct impact upon the existence/non-existence of any unfunded pension liabilities. Therefore, the supplemental contribution could become an open-ended employer obligation on behalf of employees electing the alternative defined contribution plan. Other jurisdictions that have required supplemental contributions to mitigate against any negative fiscal impact resulting from the establishment of an alternative defined contribution plan have limited the duration of the supplemental contribution to the current amortization period of the system, as determined by the system's annual actuarial valuation as of the establishment of the defined contribution plan.

Aside from the supplemental contribution, the long-term cost of the state retirement systems could be affected by a change in the demographic profile of employees choosing the defined benefit plan and by potential changes in expected rates of turnover and retirement under the defined benefit plan. Given a choice, employees will make decisions with their own economic self-interest in mind, and will choose the option which they believe will provide them with the maximum benefit. The amount of forfeited contributions available to pay the systems' liabilities that would result from the transfer of some members to an alternative defined contribution plan could outweigh any corresponding decrease in total liability that would occur as a result of the transfer. To the extent that employees can successfully make these "benefit maximizing" choices, the total benefits provided to all employees will be greater than those available under either option on a stand-alone basis. This adverse selection can be controlled, to some extent, by making any choice to opt out of the state retirement systems irrevocable, as provided under the bill for employees who are continuously employed.

- ***Portability/Recruitment*** - The bill generally raises the issue of pension portability and how to meet the retirement needs of both long-term and short-term public employees, There are three aspects to pension portability. The first involves ensuring that individuals have the right to take their vested benefit with them when they change employers. The second involves ensuring that individuals have a benefit to take with them when they change jobs, which is primarily a function of the vesting requirements under the pension plan. And the third involves ensuring that the value of an individual's benefit is not eroded by economic changes when the individual changes jobs.

With the exception of the recently-established STRS alternative benefit payout plan as noted above, none of the state retirement systems currently provide for a lump sum distribution of the member's benefit upon termination of employment. The member is eligible for a refund of the employee contributions, without any interest or employer contributions. Interest and employer contributions are retained by the state retirement systems, which lowers the employer cost for members who eventually qualify for benefits.

Members in PERS, STRS and SERS have a vested right to a retirement benefit after five years of service. PFDPF and HPRS members have a vested right to a retirement benefit after fifteen years, largely due to the career-nature of these retirement programs.

As noted above, PERS, STRS and SERS have retained the money purchase plan in order to provide some protection against the effects of inflation on the frozen benefits of members who leave public employment before retirement. Each of these systems provides the retired employee the greater of a defined benefit based on a percentage of the employee's final average earnings multiplied by years of service or a money purchase benefit based on the sum of the employee's contributions and the employer's matching contribution, both of which are credited with interest. Neither PFDPF nor HPRS provide a money purchase option for their members who leave employment before retirement, thereby causing the value of their vested defined benefit to erode due to the effects of inflation between termination of employment and retirement.

Defined contribution plans have been established in part to facilitate pension portability, particularly for younger, short-service, mobile employees. In contrast, defined benefit plans have historically been designed to attract and retain career public servants and employees entering the public sector in the mid-to-latter stages of their careers.

Under a defined contribution plan, employees generally have a right to take their retirement benefit with them when they change employers, which may be rolled over into another qualified pension plan or an individual retirement account. Depending on the plan design, they may also have an immediate vested right to the accumulated value of their retirement account upon termination of employment. Also, investment earnings continue to accrue throughout the employee's career, thus protecting the value of the benefits earned in earlier years.

Defined contribution plans have also been established in part to recruit private sector employees who arc willing to enter the public sector for short periods, especially in non-classified positions, as well as public employees from other jurisdictions, such as visiting university professors. Accordingly, other jurisdictions have established alternative defined contribution plans for select groups of public employees, such as higher education employees, legislators due to term limits, and other management-level and highly-skilled professionals.

There are, of course, numerous other approaches and combinations thereof that can be adopted by defined benefit plans to enhance pension portability for short-term employees and yet preserve the traditional benefits for long-term public employees. Vesting requirements can be reduced. Benefits after termination of employment can be indexed. A money purchase option can be adopted. An alternative benefit payout plan, such as STRS', can be established. A combination defined benefit plan funded by employer contributions and a defined contribution plan funded by the employee contributions can be adopted. An employer match to supplemental defined contribution plans can be made. And an alternative defined contribution plan within the existing defined benefit plan can be established.

- ***Law Enforcement and Public Safety Officers*** **-** The very nature of law enforcement and public safety employment calls into question the appropriateness of extending an alternative defined contribution plan to these public employees. The extensive disability and survivor coverage provided under the defined benefit plans immediately upon employment is of particular value to these public employees due to the hazardous nature of their employment. As noted above, no provision for disability or survivor benefits is made under the alternative defined contribution plan. The survivors of members of PFDPF, HPRS and PERS-LE who are killed in the line of duty or die from injuries sustained in the line of duty also qualify for benefits under the Firemen and Policemen's Death Benefit Fund. The Death Benefit Fund provides survivor benefits equal to the full monthly salary of the deceased member, plus any salary increases that would have been granted had the member not died, minus any survivor benefits paid by the state retirement system. Again, no provision for these benefits is made under the alternative defined contribution plan established under the bill.

Law enforcement and public safety officers generally tend to be career employees. However, the current vesting requirement of 15 years in these retirement systems, together with the lack of any interest or employer contributions upon a refund of employee contributions due to termination of employment, may warrant review. These provisions may actually create a financial incentive for those law enforcement and public safety officers who wish to terminate employment with less than 15 years of service to apply for disability retirement. Reducing the vesting requirements or adopting a money purchase option and/or alternative benefit payout plan in these retirement systems may not only address the issue of pension portability for these employees but also eliminate any potential disability claims.

**Fiscal Impact -** With respect to the establishment of an alternative retirement plan, the bill is designed to have no negative fiscal impact upon the state retirement systems by requiring employers to make supplemental contributions to the systems based on actuarial studies prepared by the ORSC. The PFDPF actuary states that an actuarial analysis of the long-term cost of the bill would be a very complex task, given the unknown rates of participation of PFDPF members in a defined contribution plan. In its opinion, the PFDPF actuary questions the adequacy of the initial supplemental contribution rate of 6% and the lack of any specific methodology for determining future adjustments in such rate. No actuarial cost statements have been made by either the actuary for the ORSC or the other four state retirement systems regarding the initial supplemental contribution rate of 6% as provided under the bill. The ORSC actuary is required under existing law (H.B. 586) to complete its first actuarial study, no later than July 1, 1999, to determine any necessary adjustments to this rate based on the fiscal impact of the alternative retirement plans recently established by public institutions of higher education on PERS, STRS and SERS. Current law also requires each retirement system to have prepared an actuarial analysis of all introduced retirement legislation having a fiscal impact upon the system no later than 60 days after introduction.

**ORSC Position -** The ORSC has deferred any action on H.B. 199 until the various public policy issues described above have been considered and addressed and the actuarial cost statements have been obtained.