

Research Brief

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A review of the myth and realities of Defined Benefit and Deferred Compensation Plans

Excessive Benefits in the Defined Benefit Plan Is a Myth

Average pension is small. No one is getting rich on state pensions. The average age at retirement for the largest segment of workers is 60, with 19.5 years of service, and a benefit allowance of \$1,673.82 a month. The average CHP employee retires at age 55, with 27.9 years of service, and receives an allowance of \$3,811.27 a month.

The majority of state cost increases are due to market downturn, not to increased benefits. If one considers the impact of benefit improvements in how much the state contribution has increased, the state's cost would continue to be at an historic low. Even with the negative impact in the economy included, the state employer rate for the vast majority of state employees has returned to rates in the late 70s and throughout the 1980s. It is not a record high.

Defined Contribution Plans Don't Cost Less, They Cost More

Dollar for dollar, DC plans cost more. Administrative costs of DC plans are higher – often much higher – than a DB plan.¹ The average cost for a DC plan is 2 percent of assets; the average cost of administering CalPERS defined benefit plan is 0.18 percent.

The charge for asset management is greater. The expense ratio for a stock mutual fund is 1.1 percent of assets. When you add costs for record keeping, participant education, and other administrative expenses, the annual cost of a DC plan can rise to as much as 2 percent of assets

In a typical DB plan, 80 cents of each \$1 is spent on members who retire; in a DC plan 50 cents of each \$1 is spent on benefits. For retiring members to

receive the same amount of benefits, contributions to the fund would need to increase substantially.²

A comparison of operation expenses favors DB plans. Employees pay big fees to mutual funds and other investment managers on their investment dollars in DC plans. On average, mutual funds charge \$1.35 for “load” and/or administrative expenses for every \$100 invested. For each of the last 6 years, CalPERS spent one tenth of one percent of the fund’s value – 18 cents on every \$100 invested.³

Converting to a DC plan will over time, raise costs for the DB plan. The DB plan’s unfunded liabilities would still need to be paid even if there is a conversion to a DC plan. Employer and employee contributions for employees who convert to a DC plan would go directly into an employee account and could not be used to cover unfunded liabilities in the DB plan. Over time, as the numbers of young new employees leave the DB plan, it will cause the costs to the state of the DB plan to go up. This is because pension plan liabilities rely on the continuous flow of new, younger members to help fund the cost of the plan liabilities. Any “reduction” in contributions to the DB plan will result in a lower level of assets in the DB plan available for benefits. By diverting participants from an existing DB plan to a DC plan, the DB plan costs will rise, and the employer will be required to continue to maintain the DB plan, mitigating or nullifying any expected budget savings. Moreover, the State will bear additional unknown costs to provide mandated education to participants in DC plans.

State will bear start-up costs of a DC plan, bringing to two the number of plans it will need to budget for. The state’s contributions to the CalPERS plan do not require direct payment of administrative costs to run the system. If the state were to set up a DC plan, it would have to pay for start-up costs.

The State diminishes its ability to use investment returns to cover retirement costs. A DC plan does not give the state the ability to use investment returns to meet their contributions in times of healthy markets. Higher returns in a DB plan increase the pool available for pension benefits and reduce required contribution rates. (DC costs would be constant, regardless.) Over the last 10 years, 75 percent of the income to CalPERS has been from investments, not employer or employee contributions. Over the last decade members contributions have exceeded employer contributions by \$1.1 million.

There is no guarantee that tax dollars put into an employee account will be used for retirement. Research indicates that most employees who leave one job for another, cash out their accounts – including the monies contributed by the employer for the purpose of retirement -- rather than roll them over to the next employer’s retirement plan.⁴

If DC proceeds fall short of basic retirement income needed, the state will end up paying more in public assistance when employees are old, ill and infirm.

***Replacing a Defined Benefit Plan with a Defined Contribution Model
Will Hurt California Investments***

Under the existing defined benefit plan, \$16.7 billion in pension dollars is set aside for California investments. Replacing CalPERS with a DC plan would affect the ability to use investment dollars for inner city communities, housing, and infrastructure.

***Defined Contribution Plans Threaten
Employee Retirement Security***

The benefit created by a DC plan is uncertain. This is because it is determined largely by the participant's investment decisions and ability to resist cashing out retirement assets prematurely. These are uncertain factors on which to base a worker's retirement income security. DC plan participants generally earn rates of return on investment far below what DB plan funds typically earn.⁵

But even if employees in a DC plan do manage to earn the same rate of return as a DB plan fund and resist the urge to cash out prematurely, at the end of a full career they will likely receive a smaller benefit than similar employees in the DB plan. For example, an employee in a DB plan (with a benefit formula of 2% at age 60 and employer and employee contributions of 10% of pay) hired at age 30 with a starting salary of \$25,000 and 5% pay increases each year will have a retirement benefit with a present value of \$732,100 upon retirement at age 60. In contrast, the retirement benefit for an employee in a DC plan hired at the same age with the same salary (assuming that the DB plan and DC plan both earn a rate of return of 8%) will have a present value of \$497,529 upon retirement at age 60.⁶

Employees could outlive their retirement assets in a DC plan. DC plans do not take into account the risk that the employee will outlive their retirement assets.

DC plans do not include inflation protection. For retirees in a DC plan, an annual inflation rate of 1.5 percent from age 65 to 93 would cut purchasing power in half, leaving public servants paupers. (Today's average pension for CalPERS members is \$1200 a month).

DC plans do not provide benefits for disability and death benefits.

Employees would be without either disability or death benefits in a DC plan. This is an inequitable arrangement when workers with the DB plan work along side of them. Disability & death benefits are already factored into a DB plan.

Chances that the DC plan would not provide an adequate benefit are high.

Research suggests employees do not invest well on their own to ensure an adequate benefit through their later years. An annual study conducted by Dalbar, a Boston fund consulting firm, found that the average stock fund investor had a 5 percent annual gain from 1984 to 2000; compared to a 16 percent annual average gain for the Standard & Poors (S&P) 500 stock index for that period.⁷ Over the last 10 years CalPERS returns averaged 8.23 percent and over the past 15 years, they averaged 9.38 percent.

A John Hancock Financial Services Retirement Survey of defined contribution participants published in May 2002 showed that “many have a cockeyed view of how investments work across the board.” John Hancock researchers said that most defined contribution participants will fall well shy of the estimated 75 percent of pre-retirement income needed to maintain the same lifestyle in retirement.⁸

The State of Nebraska provides a strong example of the failure of individuals in a DC plan to provide themselves with adequate income for retirement. A 2000 study found that over 20 years, public employees in a mandatory DC plan posted an average return of 6 to 7 percent, compared to 11 percent for the state’s three DB plans. Nebraska public employees in the DC plan made poor investment choices and posted weak returns even though the state gave them time off to learn how to invest, and made contributions on their behalf.⁹

Defined Contribution Plans Will Hamper Recruitment and Retention and Make State Attract Less Capable, Not More Capable Work Force

DB benefits help recruit for classifications when the State experiences a labor shortage. The State competes with local governments for many specialized workers – especially safety employees. The State has and will continue to have challenges recruiting technology workers, nurses, doctors, accountants and other specialized workers. (This occurred when the State had mandatory tier 2 programs in the early 1990s.) Human Resource specialists indicate that it is not the pay that attracts people to work for the State, but the retirement benefits. State workers have not kept pace in pay – most of whom went without annual pay raises for many of the last 13 years.¹⁰

DB plans allow employers to defer the cost of retaining employees by offering retirement benefit enhancements rather than raises. In contrast, under a DC plan, enhancing retirement benefits by increasing employer contributions would be similar to issuing raises because the costs would be borne immediately by employers.

DC plans would encourage older, more expensive workers to continue working longer, rather than retire. The performance of the markets would have a significant influence on when people retire. When the economy is doing poorly and individuals' DC accounts are down, they may work beyond their planned retirement dates, creating less opportunity for younger, less expensive workers.¹¹

Market timing would determine when people retire. Retirement trends, not age periods of market growth would spawn large numbers of employees retiring. Down markets would restrict the number of workers retiring.

DC plans will generate a new dynamic to collective bargaining. Employees would want a larger employer contribution or a higher salary due to the risks they must assume with a DB vs. DC plan and to compensate for the uneven playing field created when they must work along side of workers who have a higher benefit.

***Contrary to Popular Belief,
DC Plans Get Thumbs Down From Large Employers***

The decrease in DB plans has been limited nearly exclusively to small, not large employers. Companies that are electing to discontinue DB coverage have been small employers, not large employers, and they are doing so because of the expense of complying with complex federal regulations, most of which do not apply to the public sector.¹²

Large employers have generally kept their DB plans rather than convert to DC plans.

- **Most of the decrease in DB plans has occurred among small and medium size employers** (employers with less than 1000 employees).¹³
- **Due to their size, public employers are more comparable to large private-sector employers, most of which offer DB plans.** In 2003, 68% of large private-sector employers offered DB plans compared to 45% of all private sector employers.¹⁴
- **Although DB plans are more prevalent in the public sector, it is likely that more private sector employers would adopt or continue DB plans were it not for the cost and administrative burden imposed by ERISA laws and regulations.** Because public pension plans are exempt

from most of ERISA, DB plans are even more advantageous for public employers than for private employers.¹⁵

Only 17 percent of Fortune 100 companies have a DC plan as their primary benefit, according to Watson Wyatt. Most large employers continue to offer defined benefit plans as their primary retirement program and its use among large employers with 10,000 or more employees is increasing. The highly regarded Employee Benefits Research Institute (EBRI) found that since 1985, there was an actual increase in the number of large employers that offered a defined benefit plan as their primary retirement plan. This occurred during period of many corporate mergers of large firms, who had a unique opportunity to select one or the other.¹⁶

Public sector experience with DC conversions has not been successful. Since 1997, large numbers of public employers have been given an opportunity to participate in a DC plan as their primary retirement benefit. In Florida, Ohio and South Carolina, employer contributions equaled or exceeded their contribution to the DB plan. In Florida and Michigan, an overwhelming majority – more than 90 percent of those eligible to switch to a DC plan – elected to stay with the DB plan.¹⁷

The state of Nebraska recently converted back to a DB plan from a DC plan. A study showed that over 20 years, the typical worker posted an average annual return of 6 to 7 percent. (Money managers running the state's old-fashioned defined benefit plan ran 11 percent average returns.) Even though the state made much effort to help individuals invest wisely, half of all employees stayed in the default fund, even though they had 11 choices. Nebraska retirement system officials were concerned that the state was wasting taxpayer money via matching contributions to workers accounts.¹⁸

In Florida, where employees could leave the DB plan for the DC plan, most opted to stay in the DB plan.

The Value of “Defined Contribution Portability” Is Not What It’s Cracked Up To Be

The conventional wisdom that workers today are more mobile and want more portability of their retirement benefits is wrong.

- **Workers are not necessarily more mobile.** From 1983 to 2000, median job tenure increased or stayed the same for all workers in the U.S. with the exception of workers in two sectors (manufacturing and transportation/public utilities).¹⁹

- **Public-sector workers are even less mobile.** From 1983 to 2000, the median tenure for government workers in the U.S. increased from 5.8 years to 7.2 years. In 2000, the median years of tenure for government workers (7.2 years) was more than twice that for workers in the private sector (3.2 years).²⁰
- **DC plans are not necessarily the solution to deal with the issue of pension portability.** A significant proportion of workers with DC plans “cash out” their accounts when they change employers rather than leave it in the account or roll it over to their new employer’s plan. For example, a study conducted by the human resources consulting firm Hewitt Associates found that 57% of employees who leave their companies choose cash payments from their retirement savings plans instead of rolling over the balances to their new employer’s plans or into individual accounts.²¹
- **DB plans have been adopting changes to make benefits more portable** (e.g., shorter vesting periods and expanded reciprocity).
- **In cases where public employees have the option of participating in an alternative DC retirement plan, it appears that most opt for the DB plan.** During the first two years of Florida’s optional retirement program, only 3.4% of eligible employees opted for the DC alternative (8% of new hires).²² In Michigan, state employees hired prior to March 31, 1997 had the option to remain in a DB plan or switch to a DC plan that was mandatory for all new employees. Only 6% of eligible employees switched to the DC plan.²³

DC plan would hurt “portability” via reciprocity with public agencies within CalPERS. One of the recruitment features of the CalPERS DB plan is that there is reciprocity with other public agencies in the state; these employees would not have the same reciprocity benefit as others who work for the state.

Employees taking money out of CalPERS when they leave State service will drain the fund. The Sacramento Bee in a 1996 editorial pointed that “every worker intending to leave public service short of vesting for a pension – political appointees, highly paid managers, and professionals who have private sector skills – would likely choose the new option, draining funds from the system. That would leave taxpayers with the same pension obligations but less money to fulfill them. “

¹ “Myths and Misperceptions of Defined Benefit and Defined Contribution Plans.” A NASRA White Paper. December 2003.

² National Conference on Public Employee Retirement Systems White Paper on Defined Benefit and Defined Contribution Plan, 1997

³ Cost Effectiveness Measurement, Inc. Benefit Administration Benchmarking Analysis. May 2003.

⁴ "Myths and Misperceptions of Defined Benefit and Defined Contribution Plans." A NASRA White Paper. December 2003.

⁵ Ian McDonald, "Fundholder's Lament: All Bear, No Bull," Wall Street Journal, April, 25, 2002. And "Benefit Review Study of the Nebraska Retirement Systems." August 2000. Buck Consultants.

⁶ "The Search for Cheaper Benefits: Defined Benefit versus Defined Contribution," Public Pension Professionals, article viewed at www.pensioncube.com/Stories/DBvDC1_1.htm Feb. 2004.

⁷ Ian McDonald, "Fundholder's Lament: All Bear, No Bull," Wall Street Journal, April, 25, 2002.

⁸ "Myths and Misperceptions of Defined Benefit and Defined Contribution Plans." A NASRA White Paper. December 2003.

⁹ Benefit Review Study of the Nebraska Retirement Systems. August 2000. Buck Consultants.

¹⁰ Legislative Analyst Office 2000-01 Analysis.

¹¹ Kosiba, Louis W., Illinois Municipal Retirement Fund General Counsel. "The Defined Benefit vs. Defined Contribution Debate: The \$250 Million Question." October 13, 1999.

¹² "Myths and Misperceptions of Defined Benefit and Defined Contribution Plans." A NASRA White Paper. December 2003.

¹³ W. Michael Carter, Actuary. February 6, 1998. Letter to comment on "Pension Liberation: A Proactive Solution for the Nation's Public Pension Systems" (a report by the American Legislative Exchange Council). Published on the National Council on Teacher Retirement website www.nctr.org/content/indexpg/carter.htm. And, Kosiba, Louis W., Illinois Municipal Retirement Fund General Counsel. "The Defined Benefit vs. Defined Contribution Debate: The \$250 Million Question." October 13, 1999.

¹⁴ Hewitt Associates Newsletter, Jan. 6, 2004.

¹⁵ "Myths and Misperceptions of Defined Benefit and Defined Contribution Plans." A NASRA White Paper. December 2003.

¹⁶ "Myths and Misperceptions of Defined Benefit and Defined Contribution Plans." A NASRA White Paper. December 2003.

¹⁷ "Pension fund slowly gaining popularity." Tallahassee Democrat, Jan. 12, 2004. And Cypen and Cypen Newsletter. December, 1998. www.cypen.com/pubs/1998dec.htm

¹⁸ "Nebraska Sees Red Over its 401(k) Plans." K.C. Swanson. The Street.com. May 7, 2002. <http://www.thestreet.com/funds/belowradar/10021041.html>

¹⁹ "Employee Tenure in 2000." Bureau of Labor Statistics News Release, August 29, 2000. <http://stats.bls.gov/newsrels.htm>, p. 11.

²⁰ "Employee Tenure in 2000." Bureau of Labor Statistics News Release, August 29, 2000. <http://stats.bls.gov/newsrels.htm>, p. 11.

²¹ From *Business Insurance* Sept. 22, 1999 cited in "Are Your Retirement Benefits Important to You?" Oklahoma Public Employees Association News, April 10, 2003.
<http://www.opea.org/News/OPEA/opea-20030410e.htm>

²² "Pension fund slowly gaining popularity." Tallahassee Democrat, Jan. 12, 2004.

²³ Cypen and Cypen Newsletter. December, 1998. www.cypen.com/pubs/1998dec.htm