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Defined Contribution Plans

DC Dialogue
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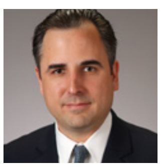
Public Workers' Reliance on DC Plans Grows

In this PIMCO *DC Dialogue*, we speak with Joshua Franzel at the Center for State and Local Government Excellence (SLGE) about changes in state and local government retirement programs in the United States. Since the 2008 financial crisis, many government plans still are working to regain a healthy defined benefit (DB) funded status, plus many governments also fund a retiree medical-cost liability. Under this financial burden, many governments have changed the availability, contribution levels and other terms of these retiree programs. Franzel tells us that states and localities are beginning to place more emphasis on supplemental DC plans or hybrid plans as a complement or replacement to DB, while a few states have made the full switch to primary DC plans. With the growing importance of saving in a DC plan, more public plan sponsors are considering automatic enrollment and other design improvements. While state and local DC plans are commonly referred to as "supplemental savings" programs, their role is increasing as they are called to cover a growing share of retirement financing and medical costs.

This dialogue is offered for general information purposes. It is not intended to give financial or professional advice.



This issue features an interview with **Joshua Franzel**, Ph.D., Vice President, Research, at the Center for State and Local Government Excellence (slge.org) in Washington, D.C.

Moderated by
Stacy L. Schaus, CFP®
PIMCO Executive Vice President and Defined Contribution Practice Leader

DC Dialogue: Can you tell us about the Center for State and Local Government Excellence (SLGE) and the database you maintain?

Joshua Franzel: Our center was established in 2007 to help state and local governments best position themselves as attractive employers. We focus on helping states and localities track demographic, compensation, benefit and workforce trends, while also highlighting promising practices. For instance, we help conduct quantitative and qualitative research on public compensation and benefits programs that help inform government decisions that affect recruiting, retaining and, ultimately, retiring their workforce. To that end, Retirement plans continue to change in many ways. When we think about state and local retirement benefits, we include the range of retirement plans – DB, DC and hybrid – in addition to retiree health care.

along with our partners, we maintain an extensive database on retirement plans, including information on almost all state and many large local defined benefit programs. We also are beginning to include defined contribution information, but have a lot more work to do in that area. We help states and localities analyze demographic and benefits data, plus we often write case studies to add context to the underlying data.

DCD: Can you tell us more about the database?

Franzel: SLGE, along with the Center for Retirement and Research at Boston College (CRR), founded the public plans database in the 2008–2009 timeframe. We recently partnered with the National Association of State Retirement Administrators (NASRA) to expand the coverage and variables collected. Today we cover about 90% of all state and local plans (measured by assets and members), plus we capture a whole host of variables, including DB funding, assumptions, contribution rates, asset allocations, investment returns, membership, governance and more. This is the most extensive database on U.S. state and local public plans. We offer free access to all of this data to government officials and anyone else who's interested, including the general public. The website is publicplansdata.org.

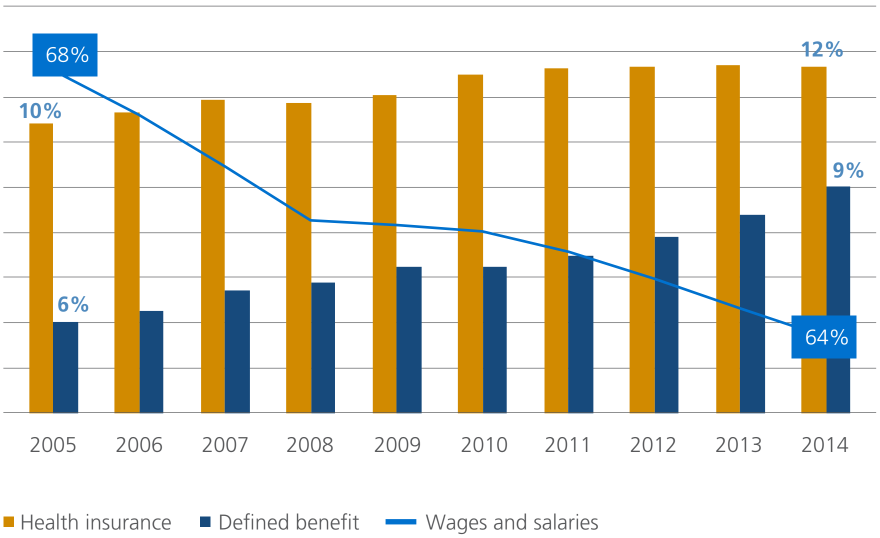
This year we rolled out a major enhancement to the database that includes a "Quick Facts" section allowing users to view national trends over time without having to dig into the background data. That said, if users prefer, they can dive into the data specific to individual states and plans. We believe this data and related research will help government employers, legislatures, councils, employee groups, the public and other stakeholders continue to evaluate and best manage retirement benefit programs.

DCD: How are public retirement plans evolving?

Franzel: Retirement plans continue to change in many ways. When we think about state and local retirement benefits, we include the range of retirement plans – DB, DC and hybrid – in addition to retiree health care. These benefits are an important part of public workers' overall compensation. Generally speaking, public workers earn less than their private-sector peers; however, they may have more attractive benefits, including both a defined benefit plan and retiree health care. These benefits tend to represent a higher percentage of their overall compensation relative to other sectors.

Over the past decade, we have seen the DB percentage of overall employer costs for employee compensation go from 6% to 9%, and health insurance from 10% to 12%. This is at a time when wages and salaries went from 68% to 64% of overall employer costs for employee compensation. DC costs remained flat over the decade at a little under 1%.

Percent of overall employer costs



Source: SLGE analysis of BLS Employer Costs for Employee Compensation, 2015

Both retirement funding and the availability of retiree health care are changing. In the future, especially given recent reforms, fewer workers will have access to a traditional DB plan, or the terms may change, reducing the value of the benefit. More emphasis will be placed on supplemental DC plans or hybrid retirement programs.

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Today, according to the Federal Reserve, aggregate state and local DB assets are about $3.8 trillion, while DC assets (457 and 403(b) plans) are just over half a trillion. Also, based on work that SLGE did with NASRA, we are seeing a trend of governments reducing or eliminating their retiree health offerings while addressing about $500 billion in unfunded retiree health care liabilities across the U.S., in aggregate.

DCD: What has driven the change in the retirement offerings?

Franzel: The 2008 financial crisis and low-return environment have presented DB funding and other challenges for states and localities. We have seen the average DB funded ratio for U.S. state and local pension programs decline from over 100% in 2000 to 74% in 2014, according to the public plans database. We anticipate this funding ratio to improve as markets rebound and a lot of the losses that were experienced in 2008 and 2009 move out of the smoothing window. We are also seeing a lot of change regarding retiree health. These changes are being driven by unfunded retiree health liabilities, continued medical inflation, and the more fluid nature of how employee and employer health costs are determined and paid for, along with the ability for states and localities to more easily reform health care benefits relative to pension benefits.

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In our 2015 state and local government workforce survey that we conducted in collaboration with the International Public Management Association for Human Resources and the National Association of State Personnel Executives, in the past year, 29% of the states and localities reported making changes to their retirement benefits, and 53% made changes to their health benefits. Unlike public pension benefits that are often protected under a state's constitution and statute, health care benefits are less likely to be protected and thus are easier to modify. That said, if we look back to 2008, we see that 48 out of 50 of the states have implemented some significant reform to their public pension plan, according to data from the National Conference of State Legislatures, NASRA and SLGE.

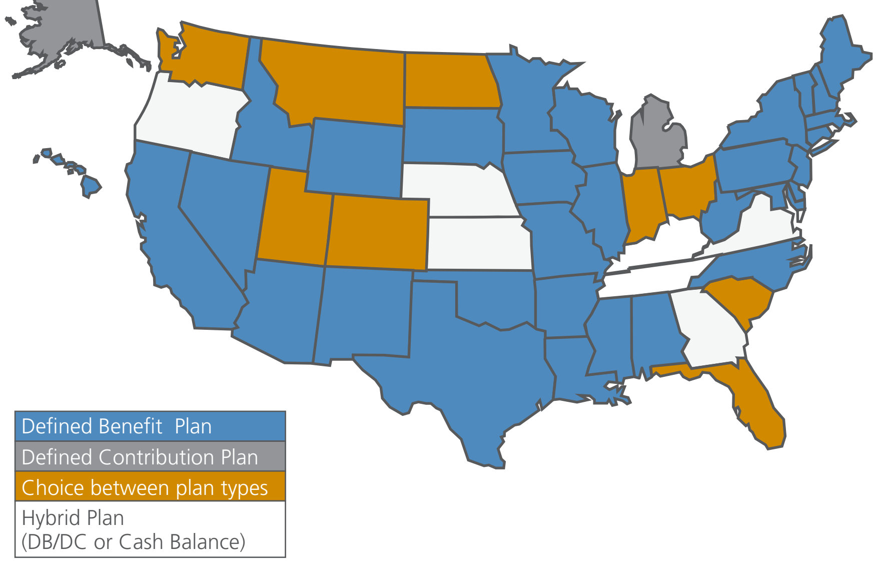
DCD: Can you tell us more about the retirement plans for public workers and about the changes that are occurring?

Franzel: Public workers may have one or more sources of retirement income, including Social Security, a DB plan, a DC plan, or a hybrid program, which may be a DB/DC combination or cash balance plan. According to BLS, as of 2014, 86% of state workers and 82% of local workers had access to a DB plan, while only 43% and 30% had access to a DC plan, respectively.

According to NASRA, about 75% of state and local workers participate in Social Security through their current jobs. About 40% of all public school teachers don't participate in Social Security, in their current roles, and about two-thirds of public safety workers don't participate in Social Security. There are some states, such as Alaska, Colorado, Louisiana, Maine, Massachusetts, Nevada and Ohio, where essentially all public employees don't participate in Social Security.

A couple of states – Alaska and Michigan – offer only a DC plan for state workers. Eight states offer a hybrid plan that is either a combination of DB and DC or a cash balance plan. Nine states offer workers a choice between plan types. There has been growing interest in the hybrid plan design.

U.S. State Pension Plan Structures
State Employees



Sources: Snell (NCSL) 'Checklist of State Defined Benefit, Defined Contribution and Hybrid Plans for State Employees and Teachers' (2012); Brainard and Brown (NASRA) 'State Hybrid Retirement Plans' (2013); Note: map developed based on what is offered to new hires

Since 2008, almost all states have implemented major reforms to their plans. These changes came in the form of increased contribution rates for new and current workers, increased vesting periods (mainly for new workers), reduced benefits, increased eligibility requirements, reduced cost-of-living adjustments, and some plan design changes.

DCD: How are the plans funded? Do workers contribute?

Franzel: It's important to note that essentially all public plans require workers to contribute a portion of their pay. According to NASRA, over the past 30 years, employer contributions have made up 26% of pension revenue, employee contributions 12%, and returns on investments 62%.

Employee contributions to DB and hybrid plans vary as a percentage of pay, depending on the plan specifics and benefit generosity. Employees who do not participate in Social Security typically pay a larger percentage of their pay, which is linked to a larger income replacement rate in retirement, relative to plans with employees who do participate in Social Security.

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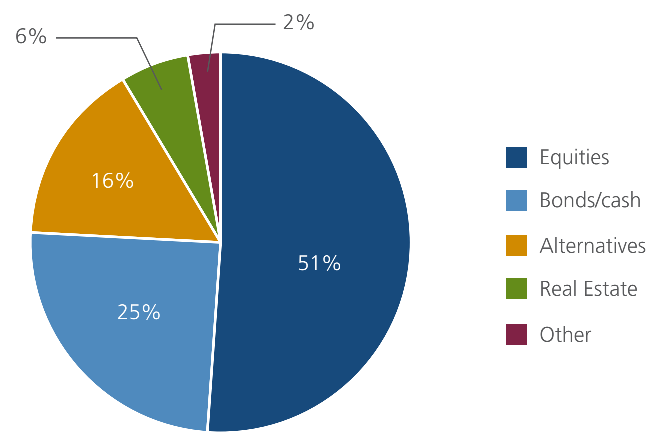
In 2013, overall, state and local DB asset allocations were 51% in equities, 25% in bonds/cash, 16% in alternatives, 6% in real estate, and the rest in other investments. Especially over the past decade or so, we have seen increased allocations in alternatives and real estate, and a reduction in the more traditional equity and fixed income categories.

DCD: You mentioned the importance of investment returns to DB funding. How has the investment structure of plans changed?

Franzel: According to our public plans data, in 2013, overall, state and local DB asset allocations were 51% in equities, 25% in bonds/cash, 16% in alternatives, 6% in real estate, and the rest in other investments. Especially over the past decade or so, we have seen increased allocations in alternatives and real estate, and a reduction in the more traditional equity and fixed income categories. For example, based on analyses of plan data we have from 2001 (a smaller data set), in the aggregate, plans had 5% in alternatives and other related investments, 3% in cash/short term, 5% in real estate, 32% in fixed income, and 55% in equities.

State legislatures, city councils, retirement boards and other entities responsible for plan oversight often need to make the decision to allow a plan to invest in nontraditional asset classes and to define at what level. Reasons often attributed to changing allocations include, but are not limited to, diversification, managing risk and optimizing returns. Depending on the system, and with exceptions, these assets may be managed almost entirely externally or both internally and externally.

State and local asset allocations – 2013



Source: http://publicplansdata.org/quick-facts/national/

DCD: In addition to contributing to either or both Social Security and a DB plan, do public workers also contribute to a DC plan?

Franzel: According to BLS data, of those with access to a DC plan, about half participate.

For DB/DC hybrid plans, based on the work of NASRA and SLGE, employees will typically contribute 0%–5% of pay for the DB component and 0%–15% of pay for the DC component. For cash balance plans, employees will typically contribute 4.5%–6% of pay.

For supplemental DC plans, there is a wide variation of offerings and employee participation rates. Also, public employers will often not provide a match, given their contributions to primary plans.

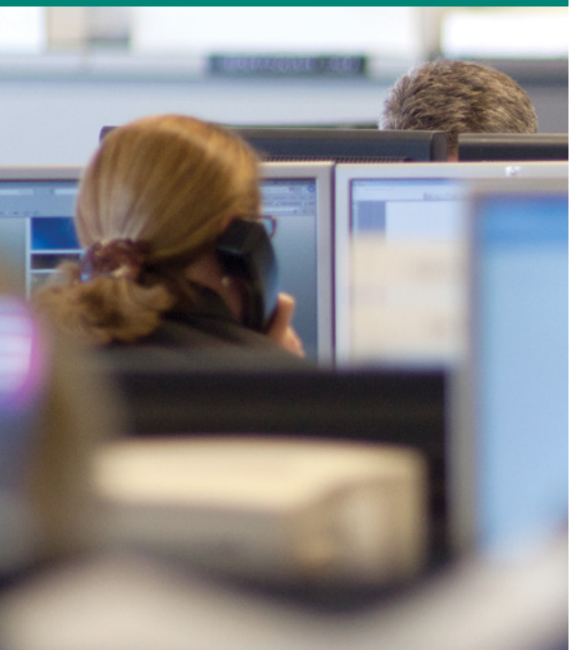
DCD: You mentioned that a couple of states, Alaska and Michigan, offer only a mandatory DC plan to general state employees.

Franzel: For general state employees hired after certain dates in those states, a mandatory DC plan is offered. Notably, both states implemented a mandatory DC program prior to the financial crisis. Alaska's program started in 2006, while Michigan's was implemented in 1996. In Alaska today, state workers do not pay into or receive Social Security. In 2015, general state workers who started working for the state after June 30, 2006 are required to contribute 8% of their pay to the mandatory DC plan; their employer contributes 5%. Michigan public employees contribute to and receive Social Security. General state employees with retiree health insurance hired after March 30, 1997 are required to participate in the primary DC plans and, in 2015, contribute a default 3% of their pay to the plan, but can increase this amount. There is also an employer contribution and match (7%). Contributions are different for those with a personal health care fund.

DCD: Can you talk more about the other DB plan reforms?

Franzel: The five-year period after the Great Recession was a time of much change for state DB plans. During this time, according to SLGE, NASRA and NCSL data, 25 states increased worker contribution rates for both current and new employees. In addition, 13 states increased the vesting period, 25 states reduced benefits, and 24 increased eligibility requirements. We have also seen 24 states reduce the cost-of-living adjustments for both active employees and retirees. And, as mentioned, we have seen some change the plan design to offer a combination of DB/DC or cash balance plan. There have been some changes since then, but the pace is slowing, and reforms have been taking place at the local level too. While DB plans remain in place and open to public

While DB plans remain in place and open to public workers, the benefit reforms, especially since 2008, often translate into a reduced benefit going forward, not only for new workers, but in many cases for existing workers and even retirees.



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DCD: Given all of the changes within DB plans, how does the role and view of DC plans change?

Franzel: Changes to DB as well as to health care plans increase the importance of supplemental DC savings in the state and local sector. While we refer to DC as "supplemental savings," these plans are a growing part of building retirement security. For workers to retire on time and support a reasonable standard of living, they will likely need a DC plan, other personal savings, and Social Security, if they participate. While there is no set retirement income objective, many folks are thinking 85% of final pay is an appropriate goal. Working longer may be an option for many, but perhaps not for public safety and other types of public roles. With this reality, there is an increased focus to improve DC plans, including considering automatic features, reducing pre-retirement withdrawals, and improving investment option sets to encourage savings, not *discourage* it.

A few years ago, Paula Sanford of the University of Georgia (UGA) and I researched and wrote the report "The Evolving Role of Defined Contribution Plans in the Public Sector," which covers many of these points.

DCD: Are public employers targeting DC plans to deliver a specific percentage of the overall 85% replacement rate?

Franzel: We have seen many states consider the replacement income expected from a DB plan and then work to have a new DC or hybrid structure keep pace with the DB replacement level. For instance, a handful of states expected DB to replace between 40% and 60% of final pay; then, when they designed plans to include a lower DB benefit and an improved DC component, the combination aimed to make up for the original DB benefit. To determine the value of DC, certain assumptions need to be made about future returns and annuity rates. Of course, it's hard to generalize what most public workers will need from their DC plan, as their sources of income and their lifestyle costs vary considerably. Nonetheless, retirement income replacement potential is important to consider.

DCD: How are DC plans viewed by workers?

Franzel: While concern remains about the risk that workers take on with DC, many place greater value on a DC plan – for instance, those workers who tend to change jobs more often. Technology workers may move between the public and private sector, so they may fail to vest in a DB plan. For these workers, a DC plan may be more attractive. By comparison, teachers and public safety officers may remain with the same or similar public employer for an entire career. So they may prefer the security and continuity of the DB plan. Now, there are many states that offer workers a choice between plans – some combination of DB, DC and hybrid. For instance, state employees have a choice in Florida, South Carolina, North Dakota, Montana, Ohio, Indiana, Utah, Washington state and Colorado. Workers appreciate having the flexibility to choose the type of plan that best fits their needs.

DCD: You mentioned that DC improvements, such as automatic features, are being considered by public plan sponsors.

Franzel: Only a few states and localities automatically enroll workers into a supplemental DC plan. This is primarily a result of state anti-garnishment laws, which typically must be changed to allow automatic DC contributions. As you can imagine, it can be quite challenging to change some of the state laws that affect public compensation and benefits.

A public employer also may use multiple recordkeepers or face operational issues in implementing auto-enrollment. Plus, some stakeholders question why auto-enrollment is needed since the DC plan is supplemental and people already have a DB benefit. Employers that like the idea of auto-enrollment often debate what percentage of pay should be defaulted into DC, especially in light of workers' required DB contribution. With all of that said, we anticipate more public plans to get over these hurdles and implement automatic programs.

SLGE has worked with Paula Sanford of UGA to study these issues and has released a series of issue briefs and reports on state and local auto features.

DCD: You mentioned that many governments are now tracking a health care liability. Will that speed the reduction or modification in the availability of retiree health care?

Franzel: Yes. States and localities are reporting their health care unfunded liabilities on their financial statements. SLGE and NASRA continue to track the unfunded health liabilities associated with state and local plans. As of fiscal year 2013, the underlying unfunded actuarial accrued liabilities associated with retiree health care plans at the state and local levels were about $500 billion.

That said, we're seeing an uptick in the number of states that are setting money aside to at least partially fund retiree health care costs. Our data shows that 33 states are setting money aside for health care funding, with about $33 billion in assets.

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The retiree health care reality will continue to drive more cost shifting to the employees and retirees, most likely in the form of higher copayments, deductibles and premiums. Other changes are happening, such as longer vesting periods and reduced coverage. A few public employers have dropped retiree medical altogether or changed to a DC model for retiree health coverage. Unlike DB plans that may be protected by state constitutions or statute, health care benefits typically do not have the same protections. As a result, health care benefits are more likely to be cut. That's another reason why DC plan availability and contributions will likely grow – retirees may look to their DC plan to help fund more of their retiree medical expenses.

DCD: Do you expect the changes in retiree medical to influence public worker retirement ages?

Franzel: Absolutely. We would expect fewer individuals retiring in their early to mid-50s. Retiree health care plans at the state and local level help early retirees fill the health care gap between when one retires and reaches Medicare eligibility. Today, according to BLS, 86% of state government employees and 66% of local government employees have access to retiree health care under the age of 65. And then 84% of state workers and 59% of local workers have access to the benefit at age 65 and above. So the health care changes will continue to affect a lot of people.

DCD: What should we expect in the coming years?

Franzel: States and localities are going through challenging times. We should expect more public plan benefit changes, especially where the plans are underfunded, but perhaps at a lower rate than just after the recession. Many of the policy conversations are about converting to a hybrid or defined contribution plan. Reducing unfunded retiree health care liabilities will also be a priority.

There are other situations where the plan might be well funded, and there still are those DC and hybrid conversations. The structure of these considerations usually revolves around ensuring fiscal sustainability, reducing employer risk, matching public- and private-sector benefits more closely, and meeting the preferences of a more mobile workforce. While we don't expect a sea change to DC plans, you will see at least a greater role and improved plan design for supplemental DC plans.

As I recently said at the SLGE Retirement Security Summit, states and localities have workforces that are getting older, a sizable portion of which is nearing or at retirement age. Many public servants with valued skill sets, who delayed career decisions in the wake of the 2008 recession, are now beginning to make moves as the overall labor and financial markets improve. We are seeing the costs of traditional retirement benefits, many of which are being reduced in generosity, taking up a larger portion of overall state and local government compensation costs, affecting the ability for governments to offer more attractive wages. How states and localities balance these factors will determine how effectively the public workforces of the future can be developed.

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DCD: Thank you for your time and insights.

Franzel: Thank you for asking me.

About PIMCO and Our DC Practice

Based in Newport Beach, California, PIMCO is a global investment management firm with over 2,000 dedicated professionals focusing on a single mission: to manage risks and deliver returns for our clients. For four decades, we have managed the retirement and investment assets for a wide range of investors, including corporations, governments, not-for-profits, and other organizations, as well as for individuals around the globe.

As of 31 March 2015 our:

- Clients include more than two-thirds the Fortune 100
- Investment professionals on staff exceed 700
- Global presence includes offices in 13 locations
- Total assets under management exceed $1.59 trillion
- DC assets under management over $130.6 billion

Our PIMCO DC Practice is dedicated to promoting effective DC plan design and innovative retirement solutions. We are among the largest managers of assets in defined contribution plans, offering investment management for stable value, fixed-income, inflation protection, equity and asset allocation strategies such as target-date solutions. We also provide analytic modeling, plus can help plan sponsors identify DC consultant resources. Our team is pleased to support our clients and the broader retirement community by sharing ideas and developments for DC plans in the hopes of fostering a more secure financial future for workers. If you have any questions about the PIMCO DC Practice, please contact your PIMCO representative or email us at pimcodcpractice@pimco.com.

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