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Assessing Public Pension Plan Objectives

by | Elizabeth Wiley



Taking a step back to assess a public pension plan's effectiveness in meeting its goals is a vital part of any effort to make plan design changes. These objectives commonly include workforce management and providing retirement security for participants while also operating within budgetary constraints.

Why do states, municipalities and other government organizations offer pension plans? In theory, plan sponsors should be able to articulate the objectives of their public pension plans (the reasons for offering them); however, few can actually do so.

The specific goals will vary between sponsors and systems, but they typically relate to three areas—workforce management, retirement security and budgetary considerations.

Most state and local pension plans were created more than 50 years ago. Significant societal and economic changes have occurred since then. In the last two years alone, the United States experienced both the Great Resignation—which saw as many as 70 million workers leave their jobs in 2021¹—and the highest levels of inflation since 1981.²

Numerous other changes have also occurred over the longer term. One of the most significant changes is the transformation to a more mobile workforce, with employees working for several employers over their careers rather than for a single employer. So even if sponsors continue to focus on the initial objectives of offering the plans, those objectives may be outdated and insufficient to ensure that the plans are still effective and efficient.

Moreover, while many public plans have updated the provisions of their system and created new benefit tiers, most of these reforms focused only on systems cost. Many reforms have had only limited, if any, explicit consideration of why the programs were originally set up, how employment trends have changed and why the sponsor continues to provide these benefits.

By primarily or exclusively focusing on the costs of the programs, plan sponsors may not be operating these plans effectively, efficiently or even as intended.

All of these considerations should serve as a reminder that pension plans don't work on a "set it and forget it" schedule. Rather, the government entities sponsoring these plans, plan administrators and trustees need to regularly assess the objectives of offering the plans and examine how well the plans are meeting these stated objectives.

This article will discuss the common objectives of public retirement systems, including examples from the operations of public pension plans, and propose a process for decision makers to consider when assessing or modifying the designs of retirement systems. The article highlights the South Dakota Retirement System³ and the Maine Participating Local Districts (PLD) Plan,⁴ where the sponsors thought carefully about the objectives before executing plan reforms.

Workforce Management

The primary objective of state and local governments is to provide services to their residents. Employees are a key part of that, and offering a retirement program can be an important tool for effectively managing the workforce. The three Rs of retirement programs in the context of workforce management are recruitment, retention and retirement. These three Rs have taken on even greater significance during the COVID-19 pandemic, resulting in rapid changes to workforce employment trends.

A well-designed and well-communicated retirement program can be a valuable component of total compensation and can help state and lo-

cal governments recruit employees. Public sector retirement programs are often considered generous, particularly when compared with the benefits offered by the private sector. Candidates for government jobs are more likely to accept these positions if they understand and value the retirement benefits they will receive, and plan sponsors have both an interest and a responsibility to ensure that they have that understanding.

Plan sponsors should consider what kind of employees they are trying to recruit when they select or modify retirement program provisions. For example, they may want to consider providing better benefits for short-term employees if they believe they are more likely to recruit workers who will stay only for a few years.

The Colorado Public Employees' Retirement Association (PERA) and the South Dakota Retirement System are among those that have tweaked their retirement plans in recent years to make them more valuable to short-term employees. Some of the incentives for members who keep their contributions in the pension plan after they terminate employment include employer contributions and continuing to pay interest on contribution balances. Colorado PERA also allows terminated employees who leave their employee contributions in the plan to purchase an annuity at the plan's assumed rate of return.

Alternatively, plans may want to offer more attractive benefits to career employees if an employer prefers recruiting employees who are likely to stay at their organization for their entire career. For example, a number of plans have considered adding deferred

retirement option plans (DROPs). DROPs are a payment option intended to increase tenure of employees by providing a lump-sum benefit in addition to the standard annuity when the employee retires. Recent examples include Arizona and Florida, which expanded access and eligibility to DROP programs in 2022, following almost two decades in which DROP provisions were more often eliminated than added.

Some sponsors offer a choice of plans to new hires to facilitate more effective recruiting. This choice typically consists of two or more options, such as a traditional defined benefit (DB) program, a defined contribution (DC) program or a hybrid program. Traditional DB plans often appeal to employees anticipating a lifelong career at the same organization, while DC or hybrid plans are more likely to appeal to employees who anticipate a shorter tenure. Offering a choice ensures that candidates can pick the retirement program that most appeals to them.

Offering a plan with an individual account option may also appeal to employees who want more control over their retirement savings. The Michigan Public School Employees' Retirement System (MPSERS), the Indiana Teachers' Retirement Fund (TRF) and the South Carolina Retirement System (SCRS) are recent examples of systems that give new members a choice among programs. State and school district employees in South Carolina may choose to participate in either the default plan (a traditional DB plan) or the optional DC plan, called the State Optional Retirement Program, when they are hired. While many choice programs allow participants to select their retirement program only early in their career (for example, within the first 90 days) SCRS participants may switch to the DB plan within five years of being hired. This extended opportunity to elect a program provides significant benefits to some members; however, it likely results in members selecting the option that is most valuable for them, which increases the sponsor's liabilities and contributions.

Plan design considerations to encourage retention are similar to those applicable to recruitment. The chosen plan design must align with the demographics of the desired population, whether it's short-term or long-term employees. Ensuring that the benefits of the retirement program are well-communicated, including education for members throughout their career regarding their estimated benefits and the benefit options available to them, is also important for retention.

For example, the Tennessee Consolidated Retirement System provides a tool to employees that combines information

takeaways

- Regularly assessing a public pension plan's objectives is an important exercise, particularly if a plan is considering changes to its provisions.
- Common pension plan objectives include workforce management, such as recruiting and retaining employees as well as planning for orderly retirements.
- Retirement security is another common plan objective. Plans may target providing a specific income replacement ratio for long-term employees or a percentage of salary for short-term workers.
- Plans must work within budget constraints to meet plan objectives. Because the actual costs of retirement programs are unknown until all benefits have been paid, plan sponsors should consider the range of possible actual costs rather than only expected costs.
- Plan sponsors that want to embark on a process of assessing their objectives and making plan modifications should consider taking the following steps: (1) identify stakeholders, (2) establish working groups, (3) document objectives and priorities, (4) evaluate the existing program, (5) propose modifications and (6) monitor results.

about retirement savings from different sources, including the supplemental savings program, Social Security, 401(k) plan balances from previous employers as well as other assets such as personal savings and home equity. The goal is to help plan participants get a better picture of their overall retirement savings progress and the benefits they are receiving from the state system.

While it is difficult to quantify the role of the retirement program in recruiting and retaining employees, anecdotal evidence supports the importance of these programs.

The 2006 closure of the DB pension plan offered by the Alaska Public Employees' Retirement System and the Teachers' Retirement System and the subsequent shift of new employees into a DC plan has been highlighted repeatedly as hurting the state's recruitment and retention efforts.^{5,6} Legislation that would reopen the DB pension plan passed the Alaska House in 2021 but did not pass the Senate in that legislative session.

Similarly, West Virginia closed its Teachers' Retirement System to new hires in 1991 and faced such setbacks in its recruitment and retention efforts that the DB plan was reopened in 2005.⁷

When considering the third R—retirement—administrators should look at how their objectives relate to specific retire-

ment program provisions. Planning for the orderly retirement of employees is a key consideration for workforce management. These provisions may include normal retirement eligibility requirements, benefit reductions for retirement prior to normal retirement eligibility and payment options such as DROPs.

Plan sponsors should consider the tradeoff between employees working longer (contributing their institutional knowledge and experience) and employees retiring at younger ages (possibly lowering the sponsor's salary needs). Sponsors may also find that increased turnover may spur more innovation in operations.

A final consideration is whether such plan design changes are likely to result in large groups of employees retiring at certain dates in order to receive the most valuable benefits. For example, the Connecticut State Employees Retirement System made changes to its cost-of-living adjustment (COLA) provisions as part of a 2017 package of plan reforms that reduced the expected benefit improvements in retirement for members retiring on or after July 1, 2022. As a result, the system saw more than double the number of retirements in fiscal year

2022 compared with the average of the previous three years.⁸ This type of mass retirement can present operational challenges to the sponsor.

Retirement Security

Objectives related to retirement security typically include those for both career employees and short-term employees.

For career employees, key objectives target a specific *income replacement ratio*—the ratio of an employee's anticipated level of retirement income compared with the employee's salary immediately before retirement. This level should factor in tax implications, adjustments to take-home pay that do not continue into retirement and the cost of health care.

For short-term employees, the key objectives are usually based on the percentage of the salary during each year of employment under the system that will support their retirement security following termination.

Finally, the level of inflation protection and whether it should be offered only to career employees or short-term employees as well is important in ensuring retirement security for members in public retirement systems. Some systems, such as the New York State Local Retirement System (NYSLRS), pay the COLA only on the first \$18,000 of benefits, providing limited inflation protection to retirees.⁹ There are also other systems, such as the Maine State Employee and Teacher Retirement Program,¹⁰ that pay the COLA on a limited portion of benefits but index the portion that receives the COLA so that retirees receive approximately the same level of benefit, in contrast to the limited inflation protection at systems such as NYSLRS.

Budgetary Considerations

Retirement programs play a key role in managing the covered workforce and providing retirement security, but the ability to offer such programs is constrained by plan sponsor budgets. This includes the anticipated cost of the programs if all assumptions are met as well as the level of risk and uncertainty about the actual costs that will emerge.

A key factor in budget considerations is the tax efficiency of retirement benefits compared with other ways in which total compensation can be offered, such as higher salaries.

While the expected cost of retirement programs is important, decision makers must also recognize that these programs are complex. The actual costs of retirement programs are unknown until all benefits have been paid, so plan sponsors must consider the range of possible actual costs. Member experience may differ from expectations, especially in the area of longevity. However, while mortality is typically the most significant demographic assumption, other assumptions such as termination, retirement and disability can have significant impacts on the ultimate actual retirement costs.

Moreover, employers need to understand the extent of their obligation for such deviations from expectations. In most traditional DB plans, the employer is solely responsible for these deviations, but members share this responsibility in plans with risk-sharing provisions.

Specific Sponsor and Plan Considerations

Every public pension plan and sponsor is unique, so it is important to consider their specific circumstances, such as whether members are covered by So-

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cial Security. If the population is not covered by Social Security, the plan must continue to meet the federal requirements for Federal Insurance Contributions Act (FICA) replacement plans¹¹ when considering changes to the programs.

Since most governments already have retirement programs in place, decision makers need to consider the existing provisions when making changes that will apply to future hires or the future service of existing employees as well as the differences in the resulting benefits packages for various employee groups.

Plan sponsors also need to consider legal protections of benefits for the covered population before making any changes. These vary by state and may prohibit certain changes, such as reductions in future benefit accruals or changes in postretirement benefit increases. Administrators need to understand the limitations applicable to their system.

Process

Changes made by the South Dakota Retirement System in 2016 and the Maine PLD Plan in 2018 are examples of thoughtful consideration of retirement program objectives when modifying the provisions.

South Dakota decided to retain the same anticipated total cost for its program while considering all aspects and provisions of the program as well as the characteristics and desires of its employees. The system created a new tier of benefits to provide more value while retaining the same overall cost.¹² The plan reforms thus reflected the plan sponsor's objectives of better meeting the needs of the current employee population and providing inflation protection through COLAs while preserving budgetary certainty with fixed contribution rates.

Key stakeholders in the South Dakota example identified one of the crucial takeaways from the effort as "articulating objectives, principles, and goals, following them with discipline, and assessing progress."¹³ This reflection supports the significance of intentionally considering objectives when evaluating program benefits.

Similarly, Maine considered its benefit structure and updated the provisions to enhance appreciation of the benefits by members of the PLD plan. Challenges from the evolution of contemporary risks, including changes in both financial markets and typical employee careers, were cited as the primary basis for the changes. Maine modified the benefits with the defined goal of better managing the risks of adverse investment and liability experience. As a result, Maine de-

bio



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veloped a risk sharing framework where these risks are routinely shared between employers and employees and retirees in cases of severe losses.

Both South Dakota and Maine began this process of revising their benefit structures by explicitly determining and documenting their retirement program objectives.

Following is a suggested process for public plan sponsors that want to embark on a similar process. The process is based on the typical objectives of plan sponsors and is used by South Dakota and Maine to determine and document the objectives for their programs.

1. Identify Stakeholders

Decision makers should identify the stakeholders who should be involved in the process: typically, budget and fiscal staff of the sponsor, legislators, and representatives of both active employees and retirees, such as labor unions and the fiduciary board of the retirement system.

2. Establish Working Groups Representing Varied Stakeholders

A working group representing all significant stakeholders should consider each of the three Rs and budgetary consider-

ations. The working groups for each of the categories should discuss both the desired outcomes and how to balance these objectives in case of conflicts, such as providing greater retirement security for members while simultaneously limiting budget increases.

This discussion should also include the level of expected cost to the employer and whether the risk of deviations from expectations—typically investment returns, inflation levels and member mortality—should be borne by either the employer or the employees or shared between them.

3. Document Objectives and Priorities

At the end of this initial process, each group should document specific objectives, list the priorities of the objectives and circulate this document to a larger group of stakeholders—including all member participants and employers within the system—and solicit feedback on the identified objectives. Each working group should then review the feedback and edit this document to develop the final objectives for the retirement system.

4. Evaluate the Existing Program

Stakeholders should systematically evaluate all provisions of the existing program, particularly any subsidies such as early retirement benefits and optional payment forms, as well as who bears the various risks of the retirement system. This process will likely include actuarial studies to determine the cost and benefits to members of all existing plan provisions, including benefits provided for termination, disability and death. Apart from studying the subsidies, the cost of any features (such as the conversion of leave balances into service or salary) should also be explicitly quantified along with the risks of variability in those costs and the benefits to members.

The overall working group should then assess these benefits compared with the previously identified objectives, highlight provisions that do not align and identify alternative provisions that would better align with the stated objectives.

5. Propose Modifications

The working group should then propose modifying provisions to best meet the stated objectives and communicate this plan to all stakeholders, offering them an opportunity for review. Based on the feedback, decision makers should

develop a final complete set of provisions for the system so that the party responsible for enacting such changes, such as the legislature or the governing board of the system, can implement them.

6. Monitor the Results

Finally, plan administrators should monitor the results of the system as they stack up against the documented objectives and consider additional revisions, if necessary.

Conclusion

Retirement programs will likely be more effective and efficient in achieving their goals when administrators make changes after deliberately developing and documenting the desired objectives of such programs. These objectives should include both workforce management and retirement security, not just the cost alone. Simply put, it is nearly impossible to assess your success if you don't know what you are trying to achieve. 📌

Endnotes

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11. Revenue Procedure 91-40 provides the testing methods for this determination, including both safe harbors for defined benefit (DB) and defined contribution (DC) plans as well as alternative testing for plans not meeting these safe harbors. The DB safe harbor includes a minimum benefit multiplier subject to adjustments based on the number of months used in the final average salary and the definition of compensation for the specific plan. The DC safe harbor is 7.5% of employee's compensation with specific considerations related to the definition of compensation and requires that earnings be created either at a "reasonable interest rate" or based on actual earnings. See www.ssa.gov/slge/revenue_procedure_91-40.htm for further details.
12. www.nasra.org/files/Topical%20Reports/Pension%20Reform/SD16.pdf.
13. Doug Fiddler "South Dakota Retirement System" presentation at Harvard Kennedy School 2022 Pension Conference: Building Better Retirement Systems: Issues and Plans, October 7, 2022.

