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AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

October 16, 2015

Members of the Arizona Legislature

The Honorable Doug Ducey, Governor

Mr. Paul Matson, Director
Arizona State Retirement System

Mr. Jared Smout, Administrator
Public Safety Personnel Retirement System

Transmitted herewith are two reports of the Auditor General, *Information Brief—A Comparison of Arizona's Two State Retirement Systems* and *Information Brief—Alternatives to Traditional Defined Benefit Plans*. These information briefs were developed in conjunction with the performance audits and sunset reviews of the Arizona State Retirement System (see Report No. 15-106) and the Public Safety Personnel Retirement System (see Report No. 15-111), which were conducted in response to an October 3, 2013, resolution of the Joint Legislative Audit Committee and as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq.

These information briefs provide additional information pertaining to the two state retirement systems and alternative types of retirement plans. The briefs do not include recommendations.

My staff and I will be pleased to discuss or clarify items in the information briefs.

Sincerely,

Debbie Davenport
Auditor General

Attachments

cc: Arizona State Retirement System Board of Trustees
Public Safety Personnel Retirement System Board of Trustees

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STATE OF ARIZONA
OFFICE OF THE
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Alternatives to Traditional Defined Benefit Plans

INFORMATION BRIEF

Our Office issued performance audits and sunset reviews of the Arizona State Retirement System (ASRS) (see Report No. 15-106) and the Public Safety Personnel Retirement System (System) (see Report No. 15-111). In these reports, we assessed efforts by the ASRS, the System, and the Legislature to ensure the sustainability of the State's four defined benefit (pension) plans that provide a guaranteed lifetime retirement benefit to public employees. We also conducted research on alternative retirement plans that do not generally guarantee lifetime benefits. This brief covers:

- Three common types of alternative retirement plans implemented by other states: defined contribution, hybrid, and cash balance plans;
- Alternative retirement plans implemented in Arizona;
- Advantages and disadvantages of these alternatives; and
- A summary of recommendations regarding these alternatives from the 2012 report of the Defined Contribution and Retirement Study Committee (Committee), which was established pursuant to Arizona Laws 2011.

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Other states have implemented alternative retirement plans

States predominately provide defined benefit plans for public employees, but alternatives to defined benefit plans have existed for some time and are receiving increased attention.[1] Defined contribution, hybrid, and cash balance plans represent the most common types of alternative retirement plans that some states have implemented (see Table 1, page 2). Although these plans' designs can vary by state, these plans generally do not offer a defined benefit or offer a smaller-than-typical defined benefit. In contrast to defined benefit plans, these alternatives do not promise to cover the full cost of a guaranteed lifetime benefit but rather give employees the opportunity to invest contributions; earn interest, dividends, and capital gains; and use their balances as needed during retirement.

Arizona has implemented some alternative retirement plans

In addition to its four defined benefit plans (see textbox), Arizona has implemented alternative retirement plans for certain state employees and elected officials. These plans include:

> **Arizona sponsors four defined benefit (pension) plans:**
>
> **Arizona State Retirement System plan**—Covers employees of participating employers, including the State and the State's counties, universities, community colleges, school districts, and municipalities.
>
> **Public Safety Personnel Retirement System plan**—Covers local, municipal, and State of Arizona public safety personnel, such as firefighters and police, and Arizona highway patrol officers.
>
> **Corrections Officer Retirement Plan**—Covers state and local corrections officers and other statutorily designated employees such as detention officers, parole and probation officers, corrections administrators, and dispatchers.
>
> **Elected Officials' Retirement Plan**—Covers elected officials and judges of certain state, county, and local governments.

- **Arizona University System Optional Retirement Plan**—As permitted by statute, the Arizona Board of Regents (Board) implemented an optional retirement plan in 1986 that allows eligible new employees at the Board and the three state universities to make an irrevocable decision within 30 days of employment to either join a defined contribution plan or the ASRS defined benefit plan. In the defined contribution plan, the employees contribute 7 percent of their gross pretax earnings, and the employers make equal contributions. Both amounts are deposited with the employees' choice of two investment companies. The employees direct how the contributions are invested, which in turn determines the value of their retirement savings balances. According

[1] Snell, R. (2012). *State cash balance, defined contribution and hybrid retirement plans*. Denver, CO: National Conference of State Legislatures.

Table 1: Comparison of states' retirement plans
As of September 2015
(Unaudited)

Retirement plan type	Description	States with plan type and years of implementation
Defined benefit plan	An employee retirement plan that provides a guaranteed lifetime retirement benefit that is calculated by a predetermined formula. The plan directs how contributions are invested.	All 50 states have at least one defined benefit plan for its public safety and general employees, including state workers and teachers.
Defined contribution plan	An employee retirement account, such as a 401(k), where the employee directs how contributions are invested. Retirement income is based solely on the amount contributed and on the investment earnings of these contributions.	Arizona (1986 and 2014), Indiana (2011), Michigan (1997), Utah (2011), and West Virginia.
Hybrid plan	A retirement plan that has a defined benefit component where the plan directs how contributions are invested and a defined contribution component where the employee directs how contributions are invested. Benefits paid from these accounts are a mix of a guaranteed lifetime benefit that is less than those yielded by sole defined benefit plans and is offset by benefits earned through the defined contribution plan component.	Florida (2000), Georgia (2009), Indiana (2011), Michigan (2010), Ohio (2002), Oregon (2003), Rhode Island (2012), Utah (2011), Virginia (2014), and Washington (1998).
Cash balance plan	An employee retirement account that is managed by a state retirement system, and member contributions are guaranteed a rate of return. Benefits paid from these accounts consist of the balance of the employee's account at retirement.	Kansas (2015), Louisiana (2013), and Nebraska (2002).

Sources: Auditor General staff review of (1) Arizona defined contribution plans in Arizona Revised Statutes; (2) retirement plan descriptions in Olleman, M., & Boivie, I. (2011). *Decisions, decisions: Retirement plan choices for public employees and employers*. Washington, DC: National Institute on Retirement Security and Seattle, WA: Milliman, and National Institute on Retirement Security. (2014). *2014 NIRS/NRTA pension education toolkit*. Washington, D.C.; (3) defined benefit retirement plans in other states in Snell, R. (2012). *State retirement plans for public safety employees*. Denver, CO: National Conference of State Legislatures and the Public Fund Survey retrieved May 26, 2014, from http://www.publicfundsurvey.org/publicfundsurvey/index.htm; and (4) alternative retirement plans in other states in Snell, R. (2012). *State cash balance, defined contribution and hybrid retirement plans*. Denver, CO: National Conference of State Legislatures.

to the Board's management, as of January 2015, about 59 percent of eligible employees had chosen the optional retirement plan over the ASRS defined benefit plan.

- **Defined Contribution Retirement Plan and the State Deferred Compensation 401(a) Defined Contribution Money Purchase Plan**—In 1999, the Legislature enacted two pilot programs to offer defined contribution plans as alternatives to the ASRS defined benefit plan. Citing the Arizona University System Optional Retirement Plan and a similar plan in Vermont, the two defined contribution plans were promoted as having four advantages over defined benefit plans: portability, less or no liability risk for the State, greater investment options for members, and less expensive administrative costs (see pages 3 through 4, for a discussion of these topics). The first pilot program was the Defined Contribution Retirement Plan for state term-limited elected officials and exempt state officers and employees. Under this plan, both the employer and employee contributed 2.66 percent of the employee's gross salary to a defined contribution account. The second pilot program was the State Deferred Compensation 401(a) Defined Contribution Money Purchase Plan for employees of the Legislature and state elected officials. Under this plan, the employer contributed 5 percent of the elected official's or employee's base salary directly to the program rather than to the ASRS.[1]

The decision to opt for these plans was irrevocable. As a result, employees were required to remain in these plans after the Legislature discontinued the pilots in 2001. As of March 2015, 43 members were in these plans.

- **Elected Officials' Defined Contribution Retirement System—**In 2013, citing a funded status of 58.4 percent and unfunded estimated pension obligations of over $600 million, the Legislature closed the Elected Officials' Retirement Plan (EORP), a defined benefit plan, to new members and established a defined contribution plan for officials elected or appointed on or after January 1, 2014.[2] Under this defined contribution plan, each member holds an individual account that is funded by an employee contribution of 8 percent of gross salary. In addition, employers make a contribution to each employee's account that is equal to 6 percent of the employee's gross salary. As of March 2015, there were 58 plan members.

Advantages and disadvantages of alternative retirement plans

Auditors' review of literature on alternative retirement plans identified both advantages and disadvantages when they are compared to defined benefit plans. Both should be considered when making decisions to implement alternative retirement plans.

Advantages—The advantages of alternative retirement plans primarily benefit employers but also benefit some employees. These include the following:

- **Stable employer contribution rates—**Alternative retirement plans can result in stable costs for the employer. For example, according to a 2012 report from the U.S. Government Accountability Office (GAO), although employer contributions to defined benefit plans generally rise and fall depending in part on investment returns, plan sponsors of defined contribution plans contribute a set amount regardless of investment returns.[3] Similarly, according to a paper from the Laura and John Arnold Foundation, defined benefit sponsors must successfully estimate the cost of future benefits using accurate predictions, such as how long employees will work, how much wages will grow, and how long members will live.[4,5] If a defined benefit plan sponsor does not make accurate predictions, it may set employer and employee contribution rates that are too low or too high to cover the costs of future benefits. In contrast, alternative retirement plans do not rely on these predictions because plan sponsors contribute a set amount, such as a specific percentage of gross salary.
- **Portability for employees—**According to the GAO's 2012 report, defined contribution plans are often viewed as more portable than defined benefit plans because employees individually own their retirement accounts and can generally take their balances with them upon termination, which could include both employer and employee contributions.[6,7] This is in contrast to defined benefit plans where employees

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1 This plan did not include a provision for employee contributions. During the pilot, employees and elected officials had access to an additional defined contribution plan if they wished to contribute toward their retirement.

2 A pension plan's funded status is its assets divided by the amount needed to pay its estimated pension obligations for benefits that have been earned by all plan members at a particular point in time. This means that in 2013, EORP had enough assets to pay 58.4 percent of its estimated pension obligations.

3 United States Government Accountability Office. (2012). *State and local government pension plans: Economic downturn spurs efforts to address costs and sustainability*. Washington, DC.

4 McGee, J.B. (2014). *LJAF solution paper: Creating a new public pension system*. Houston, TX: Laura and John Arnold Foundation.

5 Predictions are made by actuaries and are based on factors such as rates of withdrawal from the pension, mortality, disability, and wage inflation.

6 U.S. GAO, 2012.

7 Portability is dependent on plan design. Specifically, whether an employee may take his/her own contributions as well as those made by his/her employer is sometimes dependent on how long the employee has been with the plan.

may generally take their member contributions, if any, with them if they leave government employment, but not the employer's contributions. Therefore, defined contribution plans have an advantage for employees who do not wish to remain in government service for their entire careers.

Disadvantages—Despite some advantages, alternative retirement plans can increase state costs and lead to financial uncertainty for employees. Specifically:

- **Decreased ability to pay estimated pension obligations**—Implementing alternative retirement plans often does not solve underlying funding problems in existing defined benefit plans. According to the GAO's 2012 report, employers typically do not have the option of transferring current employees out of a defined benefit plan into a new defined contribution plan due to legal constraints (see Report No. 15-106, page 18, and Report No. 15-111, page 34, for more information on Arizona's legal constraints).[1] Also, according to the GAO's 2012 report, establishing an alternative retirement plan, such as a defined contribution plan, diverts contributions to individual accounts and away from paying off existing unfunded liabilities in the defined benefit plan once it is closed.[2] In addition, the National Institute on Retirement Security reports that moving new hires to a new defined contribution plan may require employers to pay off the unfunded estimated pension obligations of the existing plan faster when it is closed to new members to maintain appropriate funding stewardship.[3] Specifically, after a defined benefit plan is closed, all contributing members eventually retire and stop making their share of contributions that help fund all members' future pension benefits. If the plan is not fully funded when its last member retires, the employers or an external funding source, such as the state, will need to make contributions to pay benefits because otherwise, the plan assets will run out. This would be the case in Arizona, where pension benefits are protected by the State's Constitution.

  An example of this additional cost to the State was the closure of EORP to new members and implementation of the Elected Officials' Defined Contribution Retirement System. At the end of calendar year 2014, EORP's liabilities exceeded its assets by more than $600 million. Pursuant to Arizona Revised Statutes §38-810, from fiscal years 2014 to 2044, the Legislature is required to appropriate $5 million each fiscal year from the State General Fund to EORP to supplement the normal cost of the plan and to cover its unfunded liabilities.[4]

  Additionally, according to the National Institute on Retirement Security, state retirement systems in Alaska, Michigan, and West Virginia experienced a change in demographics after closing their defined benefit plans and opening defined contribution plans for new employees.[5] These states found that when new employees were diverted to the defined contribution plans, the number of contributing defined benefit plan members decreased as the number of retired members increased, which resulted in increased unfunded liabilities.

- **Financial uncertainty and lower investment returns for employees**—Defined benefit plans shield employees from financial uncertainty by guaranteeing a lifelong pension benefit even if investment returns and other factors are not sufficient to pay them. However, the most popular type of alternative retirement plans are the defined contribution plan and hybrid plan, which according to the GAO's 2012 report, expose employees to market risk, which in turn increases members' financial uncertainty because retirement benefits in these plans rise and fall with investment returns.[6] In addition, according to the National Institute on Retirement Security, defined benefit plans are professionally managed, which means assets are pooled and can drive down asset management costs through economies of scale, diversification, and investments held for longer periods of time.[7]

  According to the National Institute on Retirement Security, workers in Alaska, Michigan, and West Virginia who become members of new defined contribution plans face increased levels of retirement insecurity.[8] For

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1 U.S. GAO, 2012.

2 U.S. GAO, 2012.

3 Boivie, I., & Almeida, B. (2008). *Look before you leap: The unintended consequences of pension freezes*. Washington DC: National Institute on Retirement Security as cited in National Institute on Retirement Security. (2014). *2014 NIRS/NRTA pension education toolkit*. Washington, DC.

4 For more information regarding the closure of EORP, see Report No. 15-111, pages 43 through 44.

5 National Institute on Retirement Security. (2015). *Case studies of state pension plans that switched to defined contribution plans*. Washington, DC.

6 U.S. GAO, 2012.

7 Peng J., & Boivie, I. (2011). *Lessons from well-funded public pensions: An analysis of six plans that weathered the financial storm*. Washington, DC: National Institute on Retirement Security.

8 National Institute on Retirement Security, 2015.

example, in 2011, members of the Michigan defined contribution plan who were close to retirement age had an average balance of about $123,000 in their accounts, which if used to purchase an annuity would yield a lifetime benefit of about $8,200 per year. In comparison, the National Institute on Retirement Security also reports that the average defined benefit plan yields a lifetime benefit of over $20,000 per year.

- **Increased costs for employers—**Implementing alternative retirement plans increases administrative costs to state and local governments. According to the National Institute on Retirement Security, moving new hires to a new defined contribution plan can increase costs because there are additional costs to administer a second plan.[1]
- **Employees may not save enough—**According to the 2012 GAO report, similar to private sector workers with defined contribution plans, public sector workers who are members of hybrid retirement plans may not be saving enough for a secure retirement. As of the end of calendar year 2011, 80 percent of employees participating in the defined contribution component of hybrid plans were contributing only the default 1 percent despite plan officials' efforts to encourage employees to contribute more.

Arizona's 2011 Defined Contribution and Retirement Study Committee's recommendations

In 2011, the Arizona Legislature enacted Laws 2011, Ch. 357, which created the Committee to examine five areas of Arizona's pension systems and make recommendations. The Committee provided the following recommendations regarding establishment of an alternative retirement plan.[2,3]

- **Limit to new employees—**Any proposed changes that create a new defined contribution, reduced defined benefit, cash balance, or hybrid retirement plan only should apply to future employees, or as a choice to existing employees. Current employees should not be forced to move to a new retirement plan as a matter of fairness and contract law, but the Committee recommended that new alternative retirement plans be made available to existing employees who would like to opt out of membership in a defined benefit plan.[4] The Committee reported that this would assist government at all levels in attracting and retaining those employees who would like to work in government for a limited time period as a public service option and not as a career.
- **Ensure contribution rates do not increase—**If the Legislature chooses to adopt any form of a new retirement plan, the amount needed to cover the difference between plan assets and obligations of the closed plans should continue to be paid over time in such a manner as to not cause existing contribution rates to increase.
- **Require the plan to be professionally managed—**If any new retirement plan system is enacted, the funds contributed to the plan should be managed in a similar fashion as today, by professional investment staff at a state retirement system so as to reduce costs and maximize earnings for participants, such as the structure of a cash balance plan (see Table 1 on page 2).

The Committee's report stated that these practices along with other best practices that other states adopted, such as not allowing borrowing against retirement funds, should be developed and implemented for any new retirement plan.

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1 National Institute on Retirement Security, 2014.

2 Laws 2011, Ch. 357 (Senate Bill 1609), established a Defined Contribution and Retirement Study Committee to examine five areas of the State's pension systems and make recommendations. One of these areas focused on the feasibility and cost of alternative benefit plans.

3 Defined Contribution and Retirement Study Committee. (2012). *Senate Bill 1609 Defined Contribution & Retirement Study Committee final report*. Phoenix, AZ.

4 After examining literature, hearing testimony, and reviewing court cases, the Committee opined that forcing members of a defined benefit plan to a defined contribution plan would invite litigation from employees and outside groups as a violation of contract law under the Arizona Constitution.

INTEGRITY ★ ACCOUNTABILITY ★ MAKING A DIFFERENCE

Alternatives to Traditional Defined Benefit Plans

A copy of the full report is available at:

www.azauditor.gov

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