ALTERNATIVE RETIREMENT STRUCTURES

for Consideration by Arlington County's
Retirement Sustainability Workgroup

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This is in response to Workgroup members' request that I describe what would be an "ideal " design for an alternative benefit structure. AGENA has authorized me to do so. The discussion should not be construed as agreement that the current retirement system should be changed.

It is first important to identify the goals that the new structure is designed to achieve. The design elements flow directly from these goals.

Overall Purpose:

Current Defined Benefit Plan: Designed to provide a given percentage of income replacement **for life**. Normal benefit is an annuity with COLA, designed to provide **"retirement income protection**." The concern is that this plan does not serve the County's current recruitment efforts given the plan's **"long term worker**" focus.

Alternative Benefit Structure: As I understand it, the primary goal is to help attract and retain new employees who are interested in a **portable** retirement benefit that they can take in a lump sum when they leave. These workers are not looking for long term benefits. They primarily are **shorter term workers** (1) from the private sector, who are used to Defined Contribution plans, or (2) seeking a second career, who already have adequate lifetime retirement income.

Key Goals for New Structure

The following reflects the alternative's overall purpose, and other goals that I heard raised by Workgroup members:

1. **Focus is recruitment and retention of shorter term workers.**

2. **Provide "savings [or wealth] accumulation" rather than DB's "retirement income protection."**

2. **Portability.**

3. **Competitive terms, especially versus private sector 401(k)s.**

4. **Should not adversely affect DB's long term "sustainability."**

5. **Should not increase ACERS's costs on a long term or short term basis (i.e., providing alternative should not increase costs of DB over what would be expected without the change).**

6. **Protect lower salaried workers.**

OPTIONS

Two options deigned to accomplish (or at least balance) these goals are presented. My opinion is that the second of these better fulfills the stated goals as a whole. However, a more traditional DC option is also presented since the Workgroup so far has focused on such plans. There follows a summary of key provisions.

The New Hire MAP (Senior Management) DC Option

- A savings accumulation plan, targeting the Management Accountability Program (MAP) group most interested in it.
- It uses what the industry considers "best practices," except where to do so would impede stated goals such as portability.
- It incorporates protections for the DB plan and lower income workers.
- It seeks to avoid arbitrage—in other words, we don't want to let new hires "game the system" to get a higher benefit for themselves, to the detriment of other workers.
- Resulting differences from the current Workgroup alternatives include:
  - **Employer Contributions: 6% maximum (current RSW proposals start at 10%)**
    - Most private sector plans have no mandatory employer contribution at all, just a match of what the worker puts in. Maximum match tends to be 5%-6%.
    - Recommended: part mandatory and part match.
    - Different structure if applies to non-MAPs.
  - **Supplemental Contribution :** Goes to DB to cover amortization and anti-selection costs that will arise because fewer new hires are helping to fund the DB.
    - This follows best practices among plans that offer both DC and DB as primary plans (generally public sector).
  - **Do-Over (opting back into DB plan):** Shorter time (3 years for MAPs), and different formula—must buy into DB using DC's balance. Service credit based on actuarial equivalent. This reduces arbitrage.
  - **Distributions:** Use of best practices would dictate that workers cannot take their money out of the DC plan until they reach retirement age, even if they leave earlier. To account for portability, we recommend allowing workers who quit after short term service (e.g. 5-10 years) be able to take their money out.

OPTIONS, continued

The DB Individual Account Option

- Like a DC plan, this option is designed to provide **portability** for short term employees. At the same time, it is designed to provide **lifetime retirement income** for those who do stay long term.
- These goals would be achieved by adding a "cash balance" option for new hires as part of the DB's current individual account, which is now used just to credit workers' own contributions.
- Cash balance plans are common in the private sector. They provide DC-type benefits within a DB structure. Typically, a participant's **individual account is credited each year with a contribution amount and an investment return** (based on either a fixed rate or a variable rate linked to some investment return).
- The individual account balance for ACERS would consist of :
  - The 4% employee contribution already credited to the account.
  - An employer contribution—maximum 6% recommended. The % allocated would be comparable to what a DC or cash balance plan would provide, **NOT** the full DB contribution.
  - An investment credit, to be determined with input from ACERS and plan actuaries. It could be
    - A fixed % (e.g. 5%)
    - Variable rate tied to a conservative benchmark (e.g.30 year treasuries).
    - A "market rate" tied to a % of ACERS's return. It should **NOT** be ACERS' full return because ACERS' bears risk and is managing funds.
- The Individual Account Option could be elected by new hires who expect to work for a short term. If they end up staying in County service on a long term basis (e.g. more than 5-10 years), the option would expire and they would continue in the DB plan.
  - Other alternatives could be considered, such as giving that worker the option at the end of the period to take the account balance but no longer participate in the retirement system (other than existing 401(a)/457).
- While costs for the DB would increase some, the **costs would be significantly less than funding a stand-alone DC plan** for these workers.
- It would also **reduce the potential adverse impact on DB funding obligations** that DCs can present.

ADVANTAGES and DISADVANTAGES

Savings Accumulation DC Option

PROS

- **Portability** for those with short Arlington careers.
- Provides workers who want to do so the opportunity to invest their own money.
- Familiar structure.
- More than competitive with private sector, which average a
  - **5% to 6% match**.
- Excellent recruitment tool.

CONS

- **Employee bears full investment risk.**
- Anti-selection can occur, especially with do-over.
- If worker stays **long term, likely to have markedly lower benefits than DB.**
- Potential for adverse impact on DB plan—at a minimum, for comparative purposes, but also can increase plan funding costs.
- Amortization costs for Arlington's 1.7% enhancement (started about 6% of salary per year) will increase on a per worker basis.
  - But supplemental contribution can cover.
- Significant new education required, both on choice of option and investment selections.

DB Individual Account Option

PROS

- **Portability** for those with short Arlington careers.
- **Retirement income protection** for workers who end up staying long term.
- Option should **cost less** in DB plan than in separate DC.
- **Less risk to current retirement system** since new hires & their funds stay in DB.
- Excellent recruiting tool, providing upside and downside protection for those taking option.
  - Excellent returns expected, given ACERS track record. DBs typically outperform DCs .
  - Smaller or no losses in bear markets.
- No-worries investment approach for workers. Less education required.

CONS

- Novel, unfamiliar approach. Yet
  - Arlington has always taken a forward looking, leadership role in crafting solutions.
  - Most private sector workers are familiar with cash balance plans, so understand concept.
- May not appeal to worker truly intent on managing assets.
  - But given greater downside protection & good upside, few are likely to object.

Attachment

WHAT SUPPLEMENTAL CONTRIBUTIONS COVER AND WHY

Private sector companies with DB plans in place typically do not continue that plan if they want to adopt a DC plan. Instead they shut down the DB plan, and use the assets to buy participants annuities based on the value of earned benefits to date. This is a straightforward process, and no future DB funding is involved.

Arlington—like most state and local governments—is not contemplating such a drastic change. This is good public policy (if the decision to adopt a DC has been made). It does, however, raise additional DB funding issues when both options exist.

Why Supplemental Contributions Have Been Added to Public DC Plans

- **Amortization costs:** DC option shifts existing amortization costs that new hires would have born to remaining participants. Supplemental contribution accounts for the part new hires would have paid.
- **Possible New Cost**s: New DB costs can be created due to the dual plan structure, e.g.:
  - Anti-selection impact.
  - Quicker amortization of unfunded liabilities due to loss of new entrants.
- **Supplemental benefits**: that would otherwise be covered by the DB, such as death and disability.

Why Arlington Needs a Supplemental Contribution if it Adopts a DC Option

1. Provides transparency of real cost of DC option.
2. Otherwise, already sizable cost of DB (due to 1.7% enhancement, etc.) will look continually worse.
3. Current projections, without accounting for increases due to adopting a DC option, are:

	Current system Costs*	6% Employer Contribution DC
FY 2012	18.8%	6.0%
2013	20.8%	6.0%
2014	22.8%	6.0%
2015	24.8%	6.0%
2016	26.8%	6.0%
2017	28.8%	6.0%

*Includes DB and 4.2% to 401(a)/457